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VITAL SIGNS INC
Form 10-Q
August 16, 2004

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

(Mark one)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2004

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER: 0-18793

VITAL SIGNS, INC.

(Exact name of registrant as specified in its charter)

New Jersey
(State or other jurisdiction of
incorporation or organization)

11-2279807
(I.R.S. Employer
Identification No.)

20 Campus Road
Totowa, New Jersey 07512
(Address of principal executive office, including zip code)

973-790-1330
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year,
if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange Act of
1934 during the preceding 12 months (or for such shorter period that the
registrant was required to file such reports) and (2) has been subject to such

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filing requirements for the past 90 days. Yes [X] No []

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [X] No []

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

At August 12, 2004 there were 12,709,047 shares of Common Stock, no par value, outstanding.

VITAL SIGNS, INC.

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PART I.
FINANCIAL INFORMATION

Item 1. Financial Statements

Certain information and footnote disclosures required under generally accepted accounting principles have been condensed or omitted from the following consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission. Vital Signs, Inc. (the "registrant", the "Company", "Vital Signs", "we", "us", or "our") believes that the disclosures are adequate to assure that the information presented is not misleading in any material respect. It is suggested that the following consolidated financial statements be read in conjunction with the year-end consolidated financial statements and notes thereto included in the registrant's Annual Report on Form 10-K for the year ended September 30, 2003.

The results of operations for the interim periods presented herein are not necessarily indicative of the results to be expected for the entire fiscal year, or any other period.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
VITAL SIGNS, INC.

We have reviewed the accompanying consolidated balance sheet of Vital Signs, Inc. and Subsidiaries as of June 30, 2004 and the related consolidated statements of income for the three months and nine months ended June 30, 2004 and 2003, and the consolidated statements of cash flows for the nine months ended June 30, 2004 and 2003. These financial statements are the responsibility

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of the Company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the consolidated financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Vital Signs, Inc. and Subsidiaries as of September 30, 2003 and the related consolidated statements of income, stockholders' equity and cash flows for the year then ended (not presented herein); and in our report dated November 5, 2003, except for the fourth paragraph of Note 16, as to which the date is December 26, 2003, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of September 30, 2003 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

GOLDSTEIN GOLUB KESSLER LLP

New York, New York
July 23, 2004

VITAL SIGNS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| | June 30, 2004 ---- | Septembe 2003 ---- |
|---|--|--------------------------|
| | (In thousands of dolla (Unaudited)) | |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 72,530 | \$ 55,6 |
| Accounts receivable, less allowance for rebates and doubtful accounts of \$8,792 and \$7,075, respectively | 27,043 | 29,4 |
| Inventory | 19,408 | 21,8 |
| Prepaid expenses | 2,736 | 3,2 |
| Other current assets | 1,718 | 4,1 |

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| | | |
|--|-----------|---------|
| Assets of discontinued business | -- | 2,1 |
| | ----- | ----- |
| Total Current Assets | 123,435 | 116,4 |
| Property, plant and equipment--net | 32,920 | 32,3 |
| Goodwill | 69,506 | 69,5 |
| Deferred income taxes | 443 | 1,5 |
| Other assets | 2,637 | 3,3 |
| | ----- | ----- |
| Total Assets | \$228,941 | \$223,0 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 4,953 | \$ 6,0 |
| Current portion of long-term debt | -- | 1,6 |
| Accrued expenses | 6,203 | 6,0 |
| Accrued income taxes | 3,997 | 3,3 |
| Other current liabilities | 120 | 2 |
| Liabilities of discontinued business | -- | 5 |
| | ----- | ----- |
| Total Current Liabilities | 15,273 | 17,9 |
| | ----- | ----- |
| Minority interest in subsidiary | 3,273 | 2,9 |
| | ----- | ----- |
| Commitments and contingencies | | |
| Stockholders' Equity | | |
| Common stock--no par value; authorized 40,000,000 shares, issued and outstanding 12,709,047 and 12,915,566 shares, respectively | 23,946 | 30,4 |
| Accumulated other comprehensive income | 2,287 | 1,8 |
| Retained earnings | 184,162 | 169,9 |
| | ----- | ----- |
| Stockholders' equity | 210,395 | 202,2 |
| | ----- | ----- |
| Total Liabilities and Stockholders' Equity | \$228,941 | \$223,0 |
| | ===== | ===== |

(See Notes to Consolidated Financial Statements)

VITAL SIGNS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

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| | |
|---|-------|
| Net Revenues: | |
| Net sales..... | \$ 37 |
| Service revenue..... | 8 |
| | 45 |
| Cost of goods sold and services performed: | |
| Cost of goods sold..... | 17 |
| Cost of services performed..... | 4 |
| | 21 |
| Gross profit..... | 23 |
| Operating expenses: | |
| Selling, general and administrative..... | 12 |
| Research and development..... | 1 |
| Other expense--net..... | |
| Total operating expenses..... | 14 |
| Operating Income..... | 9 |
| Other (income) expense..... | |
| Interest (income)..... | |
| Interest expense..... | |
| Total other (income) | ----- |
| Income from continuing operations before provision for income taxes and minority interest in income of consolidated subsidiary..... | 9 |
| Provision for income taxes..... | 3 |
| Income from continuing operations before minority interest in income of consolidated subsidiary..... | 6 |
| Minority interest in income of consolidated subsidiary..... | |
| Income from continuing operations..... | 6 |
| Discontinued Operations: | |
| Income (loss) from operations of Vital Pharma, net of income taxes (benefit) of \$38 and (\$1,300)..... | |
| Net income..... | \$ 6 |
| Earnings per Common Share: | |
| Basic | |
| Income per share from continuing operations..... | \$ |
| Income (loss) per share from discontinued operations..... | \$ |
| Net earnings per share | \$ |
| Diluted | |
| Income per share from continuing operations..... | \$ |
| Income (loss) per share from discontinued operations..... | \$ |
| Net earnings per share..... | \$ |
| Basic weighted average number of shares outstanding..... | 12 |
| Diluted weighted average number of shares outstanding..... | 12 |
| Dividends paid per share..... | \$ |

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(See Notes to Consolidated Financial Statements)

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VITAL SIGNS, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

| | F M |
|--|--------|
| | ----- |
| | 200 |
| | ----- |
| | In t |
| | (per |
| Net Revenues: | |
| Net sales..... | \$ 111 |
| Service revenue..... | 24 |
| | ----- |
| | 136 |
| Cost of goods sold and services performed: | |
| Cost of goods sold..... | 53 |
| Cost of services performed..... | 13 |
| | ----- |
| | 67 |
| Gross profit..... | 69 |
| | ----- |
| Operating expenses: | |
| Selling, general and administrative..... | 37 |
| Research and development..... | 5 |
| Impairment charge for China operations..... | -- |
| Other expense--net..... | -- |
| | ----- |
| Total operating expenses..... | 43 |
| | ----- |
| Operating Income..... | 25 |
| | ----- |
| Other (income) expense..... | |
| Interest (income)..... | |
| Interest expense..... | |
| | ----- |
| Total other (income) expense..... | |
| | ----- |
| Income from continuing operations before provision for income taxes and minority interest in income of consolidated subsidiary..... | 26 |
| Provision for income taxes..... | 9 |
| | ----- |
| Income from continuing operations before minority interest in income of consolidated subsidiary..... | 17 |
| Minority interest in income of consolidated subsidiary..... | |

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| | |
|--|-------|
| Income from continuing operations..... | 16 |
| Discontinued Operations: | |
| Loss from operations of Vital Pharma, net of income tax benefit of (\$54) and (\$2,503)... | ----- |
| Net income..... | \$ 16 |
| | ===== |
| Earnings (loss) per Common Share: | |
| Basic | |
| Income per share from continuing operations..... | \$ |
| Loss per share from discontinued operations..... | \$ (|
| | ----- |
| Net earnings per share..... | \$ |
| | ===== |
| Diluted | |
| Income per share from continuing operations..... | \$ |
| Loss per share from discontinued operations..... | \$ (|
| | ----- |
| Net earnings per share..... | \$ |
| | ===== |
| Basic weighted average number of shares outstanding..... | 12 |
| Diluted weighted average number of shares outstanding..... | 12 |
| Dividends paid per share..... | \$ |

(See Notes to Consolidated Financial Statements)

VITAL SIGNS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | For the Nine Months Ended June 30, | |
|---|---------------------------------------|----------|
| | 2004 | 2003 |
| | ---- | ---- |
| | (In thousands of dollars) | |
| Cash Flows from Operating Activities: | | |
| Net income | \$ 16,565 | \$ 8,771 |
| Add loss from discontinued operations | 102 | 4,502 |
| | ----- | ----- |
| Income from continuing operations | 16,667 | 13,273 |
| Adjustments to reconcile income from continuing operations to net cash provided by continuing operations | | |
| Depreciation and amortization | 3,368 | 3,310 |
| Deferred income taxes | 1,076 | 136 |
| Minority interest in income of consolidated subsidiary | 373 | 236 |
| Non cash loss on write off of China receivable | -- | 553 |
| Increase in rebate allowance | -- | 3,300 |
| Changes in operating assets and liabilities: | | |
| Decrease in accounts receivable | 2,688 | 2,434 |
| Decrease in inventory | 2,866 | 59 |
| Decrease in prepaid expenses and other current assets | 2,984 | 619 |

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| | | |
|--|-----------|-----------|
| Decrease (increase) in other assets | 686 | (308) |
| (Decrease) increase in accounts payable | (1,698) | 586 |
| (Decrease) in accrued expenses | (4) | (678) |
| Increase in accrued income taxes | 605 | 5,190 |
| Increase in other liabilities | 99 | 308 |
| | ----- | ----- |
| Net cash provided by continuing operations | 29,710 | 29,018 |
| Net cash used in discontinued operations | (140) | (1,801) |
| | ----- | ----- |
| Net cash provided by operating activities | 29,570 | 27,217 |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Net proceeds from sales of assets of Vital Pharma | 417 | -- |
| Net proceeds from sale of Vital Pharma real estate | 1,222 | -- |
| Acquisition of property, plant and equipment | (3,186) | (2,269) |
| Capitalized software costs | (421) | (369) |
| Capitalized patent costs | (86) | (353) |
| Proceeds from sales of available for sale securities | -- | 82 |
| | ----- | ----- |
| Net cash used in investing activities | (2,054) | (2,909) |
| | ----- | ----- |
| Cash flows from financing activities: | | |
| Dividends paid | (2,330) | (1,833) |
| Proceeds from exercise of stock options | 1,099 | 501 |
| Purchase of common stock | (7,620) | (2,312) |
| Principal payments on long-term debt and notes payable | (1,690) | (249) |
| | ----- | ----- |
| Net cash used in financing activities | (10,541) | (3,893) |
| | ----- | ----- |
| Effect of foreign currency translation | (105) | 1,491 |
| | ----- | ----- |
| Net increase in cash and cash equivalents | 16,870 | 21,906 |
| Cash and cash equivalents at beginning of period | 55,660 | 29,303 |
| | ----- | ----- |
| Cash and cash equivalents at end of period | \$ 72,530 | \$ 51,209 |
| | ===== | ===== |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the nine months for: | | |
| Interest..... | \$ 65 | \$ 138 |
| Income taxes..... | \$ 5,614 | \$ 3,698 |

(See Notes to Consolidated Financial Statements)

VITAL SIGNS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. The consolidated balance sheet as of June 30, 2004, the consolidated statements of income for the three and nine months ended June 30, 2004 and 2003, and the consolidated statements of cash flows for the nine months ended June 30,

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2004 and 2003, have been prepared by Vital Signs, Inc. (the "registrant", the "Company", "Vital Signs", "we", "us", or "our") and are unaudited. In the opinion of management, all adjustments necessary to present fairly the financial position at June 30, 2004 and the results of operations for the three months and nine months ended June 30, 2004 and 2003, and the cash flows for the nine months ended June 30, 2004 and 2003, have been made.

2. See the Company's Annual Report on Form 10-K for the year ended September 30, 2003 (the "Form 10-K") for additional disclosures relating to the Company's consolidated financial statements.

3. At June 30, 2004, the Company's inventory was comprised of raw materials of \$11,333,000 and finished goods of \$8,075,000. At September 30, 2003, the Company's inventory was comprised of raw materials of \$12,570,000 and finished goods of \$9,287,000.

4. For Details of Legal Proceedings, see Part II, Item 1, "Legal Proceedings".

5. Net revenues consist of product sales and service revenues. For substantially all product sales, revenue is recognized in the same period as title to the product passes to the customer. For service revenue, revenue is recorded when the service is performed. A component of product sales is a deduction for rebates due on sales to distributors (see Footnote 13). A reconciliation of gross to net sales is provided below:

| | Three Months Ended June 30, | | Nine Months Ended June 30, | |
|-------------------------|--------------------------------|-----------|-------------------------------|------------|
| | 2004 | 2003 | 2004 | 2003 |
| | ----- | ----- | ----- | ----- |
| | (In thousands of dollars) | | | |
| Gross sales..... | \$ 50,786 | \$ 50,520 | \$ 150,035 | \$ 143,538 |
| | ----- | ----- | ----- | ----- |
| Rebates..... | (12,445) | (10,911) | (35,199) | (33,436) |
| Other deductions..... | (986) | (709) | (3,003) | (3,110) |
| | ----- | ----- | ----- | ----- |
| Net sales..... | 37,355 | 38,900 | 111,833 | 106,992 |
| Service revenues..... | 8,316 | 9,271 | 24,323 | 28,000 |
| | ----- | ----- | ----- | ----- |
| Total net revenues..... | \$ 45,671 | \$ 48,171 | \$ 136,156 | \$ 134,992 |
| | ===== | ===== | ===== | ===== |

Other deductions consist of discounts, returns and allowances for credits.

6. The Company has aggregated its business units into four reportable segments, Anesthesia, Respiratory/Critical Care, Sleep and Pharmaceutical Technology Services. There are no material intersegment sales. Anesthesia and Respiratory/Critical Care share certain manufacturing, sales and administration costs; therefore the operating profit, total assets, and capital expenditures are not specifically identifiable. However the Company has allocated these shared costs on a net sales basis to arrive at operating profit for the anesthesia and respiratory/critical care segments. Total assets and capital expenditures for anesthesia and respiratory/critical care have also been allocated on a net sales basis. Management evaluates performance on the basis of the gross profits and operating results of the four business segments. Summarized financial information concerning the Company's reportable segments is

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shown in the following table:

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VITAL SIGNS, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)
 (Unaudited)

| | Anesthesia ----- | Respiratory/ Critical Care ---- | Sleep ----- | Pharmaceutical Technology Services ----- | Other ----- |
|----------------------------|---------------------------|--|----------------|---|----------------|
| | (In thousands of dollars) | | | | |
| For the Three Months Ended | | | | | |
| June 30, 2004 | | | | | |
| Net revenues..... | \$ 20,716 | \$ 10,132 | \$ 10,976 | \$ 3,847 | \$ - |
| Gross profit..... | 11,670 | 5,573 | 5,194 | 1,427 | - |
| Operating income..... | 5,813 | 2,843 | 428 | 352 | - |
| 2003 | | | | | |
| Net revenues..... | \$ 19,498 | \$ 12,373 | \$ 11,810 | \$ 4,490 | \$ - |
| Gross profit..... | 10,027 | 6,348 | 5,265 | 2,143 | - |
| Operating income..... | 5,009 | 2,473 | 1,027 | 662 | - |
| For the Nine Months Ended | | | | | |
| June 30, 2004 | | | | | |
| Net revenues..... | \$ 58,715 | \$ 31,919 | \$ 34,152 | \$ 11,370 | - |
| Gross profit..... | 31,724 | 17,396 | 15,563 | 4,433 | - |
| Operating income..... | 14,939 | 8,121 | 1,819 | 979 | - |
| Total assets..... | 112,917 | 61,385 | 36,227 | 18,412 | - |
| Capital expenditures..... | 1,407 | 765 | 1,075 | 446 | - |
| 2003 | | | | | |
| Net revenues..... | \$ 54,010 | \$ 34,975 | \$ 34,950 | \$ 14,357 | \$ (3) |
| Gross profit..... | 28,727 | 18,804 | 15,683 | 6,798 | (3) |
| Operating income..... | 13,426 | 7,983 | 2,901 | 2,395 | (3) |
| Total assets | 99,877 | 64,677 | 37,254 | 19,653 | - |
| Capital expenditures..... | 1,514 | 981 | 121 | 375 | - |

* "Other" relates to an adjustment for the allowance for rebates in the three and nine months ended June 30, 2003 in the anesthesia and respiratory/critical care business segments.

7. Other comprehensive income for the three months and nine months ended June 30, 2004 and 2003 consisted of:

Three Months Ended

Nine Months Ended

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| | June 30, | | June 30, | |
|-----------------------------------|---------------------------|----------|-----------|-----------|
| | 2004 | 2003 | 2004 | 2003 |
| | (In thousands of dollars) | | | |
| Net income | \$ 6,098 | \$ 3,788 | \$ 16,565 | \$ 8,771 |
| Foreign currency translation..... | 62 | 1,584 | 460 | 2,484 |
| Other..... | -- | (35) | -- | (33) |
| Comprehensive income..... | \$ 6,160 | \$ 5,337 | \$ 17,025 | \$ 11,222 |

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VITAL SIGNS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS-- (Continued)
(Unaudited)

8. During the third quarter of fiscal 2004, the Company charged to other expense \$197,000 of costs related to a failed acquisition attempt. These expenses were allocated to the Anesthesia and Respiratory/Critical Care segments.

9. During the second quarter of fiscal 2004, the Company's Breas subsidiary expensed \$175,000 of discontinued product inventory, \$94,000 of estimated costs for a field upgrade, and \$94,000 to increase the reserve for service stock inventory. These expenses were allocated to the Company's Sleep segment.

10. During the first quarter of fiscal 2004, included in selling, general and administrative expenses are \$235,000 of expenses related to a special review performed by the Company's Audit Committee, and \$139,000 of unamortized cost related to the prepayment of the Company's Industrial Revenue Bond of \$1,500,000. These expenses were allocated to the Anesthesia and Respiratory/Critical Care segments.

11. During the third quarter of fiscal 2003, the Company wrote-off certain inventory amounting to \$647,000. A total of \$397,000 related to the Respiratory / Critical Care segment of the Company's business and \$250,000 related to the Company's Breas subsidiary, a part of the Company's Sleep segment. Also, in the third quarter of fiscal 2003, the Company expensed to cost of goods sold, \$243,000 for a twelve-month volume related expense adjustment from a supplier, which was also allocated to the Anesthesia and Respiratory/Critical Care segments.

12. During the third quarter of fiscal 2003 accounting and legal expenses of \$262,000 were incurred in connection with the Audit Committee review a complaint filed against the Company and two of its officers and related proceedings. At the request of management, the Company's Audit Committee hired outside independent accountants and legal counsel to review the matters alleged by the plaintiff, a former CFO of the Company. These expenses were included in

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selling, general and administrative expenses and were allocated (on a net sales basis) to the Anesthesia and Respiratory/Critical Care segments.

13. During the second quarter of fiscal 2003, the Company reviewed and adjusted its estimate for rebates due to distributors. As background, the Company's sales to distributors in the domestic anesthesia and respiratory/critical care business segments, which represented 25.6% of the Company's net sales during the third quarter of fiscal 2004, are made at the Company's established distributor price. Since the end-user (i.e., a hospital) is typically entitled, on a case by case basis, to a price lower than our established price, the distributor is due a rebate (the difference between the established price and the lower price to which the end-user is entitled) when shipment is made to the end user. In order to properly reflect sales to distributors, the Company records the gross sale (at our established price), less the amount of expected rebate to arrive at net sales. This net sale is the amount the Company expects to receive in cash from the distributor on the sale.

On a monthly basis, each distributor provides the Company with documentation of shipments to particular end-users and computes a rebate claim on such shipments. Once the distributor has provided us with this claim, they will deduct the computed rebate from their net remittance.

The amount of estimated rebate that has not yet been claimed by the distributor through the reduction of a payment is included in the allowance for rebates, which reduces the accounts receivable on the Company's balance sheet. This allowance is calculated by adding (1) the amount of rebates the distributors have documented is due but not yet claimed and (2) an estimate of the amount of future rebates due on any inventory the distributors are holding at the end of each period.

For several years, the Company utilized an historical moving average calculation (comparing rebates to sales to distributors) in order to estimate the amount of rebate expense that should be recorded against gross sales in each period. Based upon a review conducted in connection with the filing of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2003, the Company concluded that our estimated allowance as calculated in the previous paragraph was greater than previously calculated. As a result of its review of the rebate allowance, we recorded an additional allowance for rebates of \$3,300,000 in the second quarter of fiscal 2003. We have continued to monitor the recorded allowance for rebates as well as the payments made against this estimate and believe we are providing a better estimate of the ultimate rebate our distributors are entitled to.

14. During the third quarter of fiscal 2003, as a result of a review of the Company's tax returns, certain state tax returns for prior periods were amended, resulting in an incremental tax expense of \$500,000, and interest expense

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of \$70,000 during the third quarter of fiscal 2003. The Internal Revenue Service (IRS) had been performing, in their normal course, an examination of the Company's 1997, 1998 and 1999 Federal tax returns. As a result of views expressed by the IRS, the Company increased its tax provision in the second quarter of fiscal 2003 by \$1,081,000, and increased interest expense by \$650,000 for the related interest due. An additional \$40,000 was charged to interest expense in the third quarter of fiscal 2003. On October 6, 2003, the Company finalized the IRS tax audit for the years 1997, 1998 and 1999.

15. During the second quarter of fiscal 2003, the Company concluded that it would be unable to collect its remaining receivable under normal terms from its China distributor, and provided a reserve against the receivable balance of \$553,000. In May 2003, the Company retained counsel in China to commence certain legal actions against its distributor in China to collect its receivable. This charge related to the Company's Anesthesia and Respiratory/Critical Care segments.

16. In the second quarter of fiscal 2003, income from continuing operations included \$322,000 of expenses relating to costs for a public offering that was discontinued due to market conditions.

17. During the second quarter of fiscal 2003, the Company had received several non-binding bids for its Vital Pharma business. Based on the non-binding bids received, the Company reduced the amount of its investment in Vital Pharma, which is included in discontinued operations, and expensed \$3,300,000 in the second quarter of fiscal 2003, and subsequently in the third quarter of fiscal 2003 expensed an additional \$2,033,000. In October 2003, the Company sold Vital Pharma to ProClinical, Inc. for \$500,000 in cash and a three-year note receivable from ProClinical for \$2,000,000. The note is secured by a first lien against all of the assets sold. No gain or further loss was recorded on the sale. On December 29, 2003 the Company sold certain related real estate. The Company has accounted for these sales on a cost recovery basis. In the quarter ended June 30, 2004 the Company received \$107,000 of interest income from Pro Clinical, which was recorded as a net gain from discontinued operations (after income tax effect) of \$69,000.

18. In December 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation--Transition and Disclosure, an amendment of SFAS No. 123". SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 "Accounting for Stock-Based Compensation", to require prominent disclosures in annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect in measuring compensation expense. The disclosure requirements of SFAS No. 148 are effective for periods beginning after December 15, 2002.

The Company has elected, in accordance with the provisions of SFAS No. 123, as amended by SFAS No. 148, to apply the current accounting rules under APB Opinion No. 25 and related interpretations in accounting for its stock options and, accordingly, has presented the disclosure-only information as required by SFAS No. 123. If the Company had elected to recognize compensation cost based on the fair value of the options granted at the grant date as prescribed by SFAS No. 123, the Company's net income and net income per common share for the three months and nine months ended June 30, 2004 and 2003 would approximate the pro forma amounts indicated in the table below (dollars in thousands):

| Three Month Period Ended June 30, | Nine Month Period Ended June 30, |
|--------------------------------------|-------------------------------------|
|--------------------------------------|-------------------------------------|

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| | 2004 | 2003 | 2004 | 2003 |
|---|----------|----------|-----------|----------|
| Net income--as reported..... | \$ 6,098 | \$ 3,788 | \$ 16,565 | \$ 8,771 |
| Net income--Pro forma..... | 5,759 | 3,688 | 15,727 | 8,471 |
| Basic net income per common share--as reported..... | .48 | .30 | 1.29 | .68 |
| Diluted net income per common share--as reported..... | .48 | .29 | 1.28 | .67 |
| Basic net income per common share--Pro forma..... | .45 | .29 | 1.23 | .66 |
| Diluted net income per common share--Pro forma..... | .44 | .28 | 1.22 | .65 |

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VITAL SIGNS, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)
 (Unaudited)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for the three months and nine months ended June 30, 2004 and 2003, respectively: expected volatility of 50% and 50%, respectively, risk-free interest rate of 3.7% and 4.2%, respectively, dividend yield rate of .7% and .7%, respectively, and all options have expected lives of 5 years.

19. The Company does not believe that any recently issued but not yet effective accounting standards will have a material effect on the Company's financial position or results of operations.

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Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition

Forward Looking Statements

This Quarterly Report on Form 10-Q contains, and from time to time we expect to make, certain forward-looking statements regarding our business, financial condition and results of operations. The forward-looking statements are typically identified by the words "anticipates", "believes", "expects",

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"intends", "forecasts", "plans", "future", "strategy", or words of similar import. In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), we intend to caution investors that there are important factors that could cause our actual results to differ materially from those projected in our forward-looking statements, whether written or oral, made herein or that may be made from time to time by or on behalf of us. Investors are cautioned that such forward-looking statements are only predictions and that actual events or results may differ materially from such statements. We undertake no obligation to publicly release the results of any revisions to our forward-looking statements to reflect subsequent events or circumstances or to reflect the occurrence of unanticipated events.

We wish to ensure that any forward-looking statements are accompanied by meaningful cautionary statements in order to comply with the terms of the safe harbor provided by the Reform Act. Accordingly, we have set forth in Exhibit 99.1 to our Annual Report on Form 10-K for the year ended September 30, 2003 a list of important factors, certain of which are outside of management's control, that could cause our actual results to differ materially from those expressed in forward-looking statements or predictions made herein and from time to time by us. Reference is made to such Exhibit 99.1 for a list of such risk factors.

Results of Operations

The following table sets forth, for the periods indicated, the percentage increase or decrease of certain items included in the Company's consolidated statement of income.

| | Increase from Prior Period Three Months Ended June 30, 2004 Compared with Three Months Ended June 30, 2003 | Increase from Prior Period Nine Months En June 30, 200 Compared wit Nine Months June 30, 2003 |
|--|--|---|
| | ----- | ----- |
| Consolidated Statement of Operations Data: | | |
| Net revenues..... | (5.2%) | 0.9% |
| Gross profit..... | 0.3% | 3.6% |
| Total operating expenses..... | (1.3%) | (0.1)% |
| Income from continuing operations..... | 12.1% | 25.6% |
| Net income..... | 61.0% | 88.9% |

Comparison of Results for the Three-Month Period Ended June 30, 2004 to the Three-Month Period Ended June 30, 2003.

Net Revenue. Net revenues for the three months ended June 30, 2004 decreased by 5.2% (a decrease of 6.1% excluding the favorable effect of foreign exchange) to \$45.7 million as compared to \$48.2 million in the comparable period last year. Of our total revenues, \$34.5 million, or 75.5%, were derived from domestic sales and \$11.2 million, or 24.5%, were derived from international sales. The following are the net revenues by business segment for the three months ended June 30, 2004 compared to the three months ended June 30, 2003.

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REVENUE BY BUSINESS SEGMENT

| | For the Quarter Ended June 30, | | Percent |
|---|-----------------------------------|-----------|---------|
| | 2004 | 2003 | Change |
| | ---- | ---- | ----- |
| | (Dollars in thousands) | | |
| Anesthesia..... | \$ 20,716 | \$ 19,498 | 6.2% |
| Respiratory/Critical Care..... | 10,132 | 12,373 | (18.1%) |
| Sleep..... | 10,976 | 11,810 | (7.1%) |
| Pharmaceutical Technology Services..... | 3,847 | 4,490 | (14.3%) |
| | ----- | ----- | ---- |
| | \$ 45,671 | \$ 48,171 | (5.2%) |
| | ===== | ===== | ===== |

Sales of anesthesia products increased 6.2% from \$19.5 million for the three months ended June 30, 2003 to \$20.7 million for the three months ended June 30, 2004. The increase is due to a 65.0% increase in sales of Limb-O(TM), our patented anesthesia circuit, to \$2,259,000, a 12.5% increase in sales of traditional anesthesia circuits to \$6,502,000, and a 25.0% increase in sales by the Company's Thomas Medical subsidiary to \$5,521,000. Domestic sales of anesthesia products increased 7.4%, from \$17,682,000 for the three months ended June 30, 2003 to \$18,984,000 for the three months ended June 30, 2004. International sales of anesthesia products decreased 4.7%, from \$1,817,000 for the three months ended June 30, 2003 to \$1,732,000 for the three months ended June 30, 2004.

Sales of respiratory/critical care products decreased 18.1%, from \$12.4 million for the three months ended June 30, 2003 to \$10.1 million for the three months ended June 30, 2004. Domestic sales of respiratory/critical care products decreased 14.9% from \$8,437,000 for the three months ended June 30, 2003 to \$7,182,000 for the three months ended June 30, 2004, primarily due to lower pricing resulting from price concessions offered to continue our partnership with the Premier Group Purchasing Organization. Our ongoing cost reduction programs have allowed us to offset these price concessions without eroding margins. International sales of respiratory/critical care products decreased 25.1%, from \$3,936,000 for the three months ended June 30, 2003 to \$2,950,000 for the three months ended June 30, 2004 resulting principally from a decrease of 26.9% in the quarter in our Arterial Blood Gas ("ABG") business to two large international OEM customers. However, the international sales of ABG's have increased by 2.3% for the fiscal year to date as compared to the same period in the prior year.

Net revenues in the Sleep segment decreased 7.1% (a decrease of 10.4% excluding foreign exchange) from \$11.8 million for the three months ended June 30, 2003 to \$11.0 million for the three months ended June 30, 2004. The Net revenues at Sleep Services of America (SSA), the Company's domestic sleep disorder diagnostic business, decreased 6.5% as a result of closing certain sleep labs that had not returned the appropriate margins. SSA has experienced a

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16.8% sales increase in the continuing sleep centers over the same period of last year. Also in this segment, revenues for Breas, our European manufacturer of personal ventilators and CPAP devices, decreased 7.4% (a decline of 12.8% excluding foreign exchange). The current Breas designs for CPAP and home ventilators do not meet the German H&H reimbursement requirements. Breas is preparing for the launch of its new family of products, which is scheduled in early fiscal 2005.

Service revenues in the Pharmaceutical Technology Services segment decreased 14.3%, from \$4.5 million for the three months ended June 30, 2004 to \$3.8 million for the three months ended June 30, 2004, as our larger pharmaceutical customers had, in the beginning of the current fiscal year, reduced their external resource usage with regards to 21 CFR Part 11 FDA regulatory compliance needs. Sales in this segment have leveled off to approximately \$3.7 to \$3.8 million in each of the last three quarters.

Cost of Goods Sold and Services Performed. Cost of goods sold and services performed decreased 10.6% from \$24.4 million for the three months ended June 30, 2003 to \$21.8 million for the three months ended June 30, 2004.

Cost of goods sold decreased \$2.4 million, or 12.1%, from \$19.5 million for the three months ended June 30, 2003 to \$17.1 million for the three months ended June 30, 2004. Included in Cost of Goods Sold for the three months ended June 30, 2003 were charges of \$647,000 for the write-down of certain inventory located at our Colorado and Breas locations, and a \$243,000 charge representing a twelve-month contractual volume related

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expense adjustment from a supplier. The balance of the decrease from the quarter ended June 30, 2003 to the quarter ended June 30, 2004 reflects the sales volume decrease at Breas, (leading to approximately \$910,000 in cost reduction, offset by \$255,000 of foreign exchange related increases in costs), and the planned reduction of costs at our New Jersey, Colorado and California plants of approximately \$650,000.

Cost of services performed decreased 4.3%, from \$4.9 million for the three months ended June 30, 2003 to \$4.7 million for the three months ended June 30, 2004, resulting primarily from reduced sales volumes in our Pharmaceutical Technology Services segment and at Sleep Services of America, our sleep disorder diagnostic company, where the business continues to close sleep labs that were not returning the appropriate margin.

Gross Profit. Our gross profit increased 0.3%; from \$23.8 million for the three months ended June 30, 2003 to \$23.9 million for the three months ended June 30, 2004. Our overall gross profit margin was 52.3% for the three months ended June 30, 2004; an increase from the 49.4% achieved in the three months ended June 30, 2003. The three months ended June 30, 2003 were effected by the inventory write-downs (\$647,000) and supplier charge (\$243,000) discussed above. Foreign exchange from our European subsidiary, Breas, increased gross profit by \$180,000 and cost improvement programs at our plants, as described above, improved gross profits by approximately \$1.1 million. These improvements were offset by sales decreases in our Respiratory/Critical Care, Sleep and Pharmaceutical Technology segments, as described above, of approximately

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\$600,000 and sales rate declines (principally resulting from increased rebates of \$1.5 million). For gross profit information related to our four segments, refer to Footnote 6 of the Notes to Consolidated Financial Statements.

Operating Expenses

Selling, General and Administrative Expenses. Selling, general and administrative expenses decreased 6.0%; from \$13.1 million for the three months ended June 30, 2003 to \$12.3 million for the three months ended June 30, 2004. The \$800,000 decrease consists primarily of reduced legal expenses of \$362,000 (primarily related to the audit committee investigation during the third quarter of fiscal 2003), \$186,000 for data processing charges incurred during the third quarter of fiscal 2003 and net cost reductions (primarily at our Breas and Stelex subsidiaries) of approximately \$379,000, offset by an increase from foreign exchange at Breas of approximately \$127,000.

Research and Development Expenses. Research and development expenses increased by approximately \$406,000, or 27.8%, from \$1.5 million for the three months ended June 30, 2003 to \$1.9 million for the three months ended June 30, 2004 relating to the development of the new Breas family of Sleep CPAP and ventilation equipment and patient interfaces.

Other (Income) Expense--Net. Other expense included in operating expenses, increased by \$193,000 from \$67,000 for the three months ended June 30, 2003 to \$260,000 for the three months ended June 30, 2004. Included in the three months ended June 30, 2004 was \$197,000 of costs related to a failed acquisition attempt.

Other Items

Interest Income and Expense. Interest income decreased \$22,000, or 10.4%, from \$211,000 for the three months ended June 30, 2003 to \$189,000 during the three months ended June 30, 2004. Interest expense decreased 100% from \$147,000 for the three months ended June 30, 2003, as the Company had paid down its Industrial Revenue Bond in the first quarter of fiscal 2004. Refer to Footnote 10 of the Notes to Consolidated Financial Statements. Also included in Interest expense during the three months ended June 30, 2003 was interest related to the examination by the Internal Revenue Service of the Company's 1997, 1998 and 1999 Federal income tax returns. Refer to Footnote 14 of the Notes to Consolidated Financial Statements.

Provision for Income Taxes. The provision for income tax expense for the three months ended June 30, 2004 and 2003 was \$3.5 million and \$3.75 million, respectively, reflecting effective tax rates of 36.1% and 40.6% for these periods, respectively. Included in the provision for the three months ended June 30, 2003 is an additional provision of \$500,000 resulting from the amending of certain state returns subsequent to the examination by the Internal Revenue Service of the Company's 1997, 1998 and 1999 Federal income tax returns. Refer to Footnote 14 of the Notes to Consolidated Financial Statements.

Discontinued Operations. The net gain (after applying the taxes) from discontinued operation was approximately \$69,000 for the three months ended June 30, 2004 and approximately \$1,590,000 for the three

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months ended June 30, 2003. In the quarter ended June 30, 2004 the Company received \$107,000 of interest income from the purchaser, Pro Clinical. Refer to Footnote 17 of the Notes to Consolidated Financial Statements.

Comparison of Results for the Nine-Month Period Ended June 30, 2004 to the Nine-Month Period Ended June 30, 2003.

Net Revenue. Net revenues for the nine months ended June 30, 2004 increased by 0.9% (a decrease of 1.3% excluding the favorable effect of foreign exchange) to \$136.2 million as compared to \$135.0 million in the comparable period last year. Of our total revenues, \$100.4 million (or 73.7%) were derived from domestic sales and \$35.8 million (or 26.3%) were derived from international sales. Following are the net revenues by business segment for the nine months ended June 30, 2004 compared to the nine months ended June 30, 2003.

REVENUE BY BUSINESS SEGMENT

| | For the Nine-Months Ended June 30, | | Percent Change |
|--|---------------------------------------|-----------|-------------------|
| | 2004 | 2003 | |
| Anesthesia..... | \$ 58,715 | \$ 54,010 | 8.7% |
| Respiratory/Critical Care..... | 31,919 | 34,975 | (8.7%) |
| Sleep..... | 34,152 | 34,950 | (2.3%) |
| Pharmaceutical Technology Services | 11,370 | 14,357 | (20.8%) |
| Rebate allowance adjustment. | -- | (3,300) | N/A |
| | ----- | ----- | ----- |
| | \$136,156 | \$134,992 | 0.9% |
| | ===== | ===== | ===== |

The rebate allowance of \$3.3 million relates to our anesthesia and respiratory/critical care segments. Refer to Footnote 13 of the Notes to Consolidated Financial Statements for a description of the rebate allowance.

Sales of anesthesia products increased 8.7% from \$54.0 million for the nine months ended June 30, 2003 to \$58.7 million for the nine months ended June 30, 2004. This increase was due to volume growth in anesthesia circuits including our Limb-O(TM), our patented anesthesia circuit, which increased 67.9% to \$5.8 million, a 9.9% increase in traditional anesthesia circuits to \$18.3 million and volume increases in our Thomas Medical Products subsidiary, which increased 26.9% to \$14.7 million. Domestic sales of anesthesia products increased 8.4%, from \$49.6 million to \$53.8 million. International sales of anesthesia products increased 11.7%, from \$4.4 million to \$4.9 million.

Sales of respiratory/critical care products decreased 8.7%, from \$35.0 million for the nine months ended June 30, 2003 to \$31.9 million for the nine months ended June 30, 2004. Domestic sales declined 13.4%, from \$25.7 million to \$22.3 million resulting from increased competition within the segment. International sales of respiratory/critical care products increased 4.2% from \$9.3 million for the nine months ended June 30, 2003 to \$9.7 million for the nine months ended June 30, 2004 reflecting higher sales volumes through our distributor arrangement in Europe with Rusch.

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Our sleep segment revenues decreased 2.3% (a decrease of 10.0% excluding favorable foreign exchange), from \$35.0 million for the nine months ended June 30, 2003 to \$34.2 million for the nine months ended June 30, 2004. Sleep Services of America's revenues decreased 5.1% from \$13.6 million for the nine months ended June 30, 2003 to \$13.0 million for the nine months ended June 30, 2004 as the Company has closed 14 sleep labs that had not returned the appropriate margins. The Company has opened 9 new sleep labs in fiscal 2004. In the continuing sleep labs, revenue increased 16.8%. Pre-tax margins in our SSA business improved to 15.4% in the nine-month period ended June 30, 2004, as compared to 9.4% in the comparable period last year. Revenues at our Breas subsidiary decreased 0.5% (a decrease of 12.8% excluding favorable foreign exchange) from \$21.3 million for the nine months ended June 30, 2003 to \$21.2 million for the nine months ended June 30, 2004. The current Breas designs for CPAP and home ventilators do not meet the German H&H reimbursement requirements. Breas is preparing for the launch of its new family of products, which is scheduled to begin in early fiscal 2005.

Service revenues in the Pharmaceutical Technology Services segment decreased 20.8%, from \$14.4 million for the nine months ended June 30, 2003 to \$11.4 million for the nine months ended June 30, 2004. Our larger

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pharmaceutical customers have reduced their external resource usage with regards to 21 CFR Part 11 FDA regulatory compliance needs. Revenues in the Pharmaceutical Technology Services segment have leveled off to approximately \$3.7 to \$3.8 million in each of the last three quarters.

Cost of Goods Sold and Services Performed. Cost of goods sold and services performed decreased 1.8% from \$68.3 million for the nine months ended June 30, 2003 to \$67.0 million for the nine months ended June 30, 2004.

Cost of goods sold increased \$300,000, or 0.5%, from \$53.3 million for the nine months ended June 30, 2003 to \$53.6 million for the nine months ended June 30, 2004. The increase resulted from sales volume increases of approximately \$900,000 in our anesthesia and respiratory/critical care segments and approximately \$1.7 million related to foreign exchange at our European subsidiary, Breas, (offset by approximately \$1.4 million related to Breas sales volume declines). These increases were offset by the planned reduction of costs at our New Jersey, Colorado, Minnesota and California of approximately \$900,000.

Cost of services performed decreased 10.1%, from \$15.0 million for the nine months ended June 30, 2003 to \$13.5 million for the nine months ended June 30, 2004, resulting primarily from reduced sales volumes in our Pharmaceutical Technology Services segment and at Sleep Services of America, our sleep diagnostics company, where the business has closed 14 sleep labs that had not returned the appropriate margins.

Gross Profit. Our gross profit increased 3.6%; from \$66.7 million for the nine months ended June 30, 2003 to \$69.1 million for the nine months ended June 30, 2004. Our overall gross profit margin was 50.8% for the nine months ended June 30, 2004 and 49.4% for the nine months ended June 30, 2003. The nine months ended June 30, 2003 were effected by the inventory write-downs (\$647,000) and supplier charge (\$243,000) discussed above. Foreign exchange at our European

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subsidiary, Breas, increased gross profits \$1.3 million and the continuing cost improvement programs at our plants and sleep centers, as described above, improved gross profits by approximately \$2.6 million. These improvements were offset by sales volume decreases in our Respiratory/Critical Care, Sleep and Pharmaceutical Technology segments (of approximately \$600,000) and sales rate declines (principally resulting from a \$1.8 million increase in rebates). For gross profit information related to our four segments, refer to Footnote 6 of the Notes to Consolidated Financial Statements.

Operating Expenses

Selling, General and Administrative Expenses. Selling, general and administrative expenses decreased 0.9%, from \$37.7 million for the nine months ended June 30, 2003 to \$37.4 million for the nine months ended June 30, 2004. The \$300,000 decrease consists primarily of net cost reductions (primarily at our Breas and Stelex subsidiaries) of approximately \$331,000 and a reduction of \$186,000 for data processing charges, offset by the write off of \$139,000 of debt acquisition costs relating to the pay-off of the \$1.5 million Industrial Revenue Bond. (See Footnote 10 of the Notes to Consolidated Financial Statements).

Research and Development Expenses. Research and development expenses increased by approximately \$1.0 million or 23.4%, from \$4.4 million for the nine months ended June 30, 2003 to \$5.4 million for the nine months ended June 30, 2004 relating to the development of new Sleep CPAP, ventilation equipment and interfaces for our Breas subsidiary.

Impairment Charge for China Operations. As described in Footnote 15 of the Notes to Consolidated Financial Statements, during the second quarter of fiscal 2003, the Company concluded that it would be unable to collect its remaining receivable under normal terms from its China distributor, and provided a reserve against the receivable balance of \$553,000.

Other Expense--Net. Other net expense included in operating expense decreased \$172,000 from \$653,000 for the nine months ended June 30, 2003 to \$481,000 for the nine months ended June 30, 2004. Included in the nine months ended June 30, 2003 were costs of \$322,000 for the costs of a public offering that was discontinued due to market conditions, \$205,000 for the closing cost for several European sales offices, \$59,000 for severance costs and \$59,000 for the closing of redundant Stelex offices. Included in the nine months ended June 30, 2004 were costs of \$197,000 related to a failed acquisition attempt, \$197,000 for severance costs and \$87,000 of net other expense.

Other Items

Interest Income and Expense. Interest income increased 14.8%; from \$500,000 for the nine months ended June 30, 2003 to \$574,000 during the nine months ended June 30, 2004, resulting from the increase in the level of

cash and cash equivalents being invested. Interest expense decreased \$849,000 from \$874,000 for the nine months ended June 30, 2003 to \$25,000 during the nine months ended June 30, 2004. Interest expense for the nine months ended June 30,

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2003 included \$760,000 of interest relating to past taxes due resulting from an Internal Revenue Service examination and interest of \$100,000 on our IRB loan, which was paid off in December 2003. (See Footnote 14 of the Notes to Consolidated Financial Statements).

Provision for Income Taxes. The provision for income tax expense for the nine months ended June 30, 2004 and 2003 was \$9.4 million and \$9.5 million, respectively, reflecting effective tax rates of 35.5% and 41.3% for these periods, respectively. Included in the provision for the nine months ended June 30, 2003 is an additional provision of \$1.1 million resulting from an examination by the Internal Revenue Service of the Company's 1997, 1998 and 1999 Federal income tax returns and \$500,000 resulting from the amending of certain state tax returns for prior periods. (See Footnote 14 of the Notes to Consolidated Financial Statements).

Discontinued Operations. On October 30, 2003 the Company sold the assets of its Vital Pharma subsidiary to Pro Clinical, Inc. The Company received \$500,000 in cash and a three-year note receivable from ProClinical for \$2,000,000. The note is secured by a first lien against all of the assets sold. No gain or further loss was recorded on the sale. On December 29, 2003 the Company sold certain related real estate. The Company has accounted for these sales on a cost recovery basis. The net loss (after applying the tax benefit) from discontinued operation was approximately \$102,000 for the nine months ended June 30, 2004 and approximately \$4,502,000 for the nine months ended June 30, 2003. (See Footnote 17 of the Notes to Consolidated Financial Statements).

Liquidity and Capital Resources

Historically, our primary liquidity requirements have been to support operations. We have funded these requirements principally through internally generated cash flow. At June 30, 2004, we had cash and cash equivalents of approximately \$72.5 million and we had no long-term debt. We have a \$20 million line of credit with JP Morgan Chase Bank. There were no amounts outstanding on the JP Morgan Chase Bank line of credit at June 30, 2004.

Vital Signs continues to generate cash flows from its operations. During the nine months ended June 30, 2004, cash and cash equivalents increased by \$16.9 million. Operating activities provided \$29.2 million net cash, of which \$29.4 million was provided from continuing operations and \$140,000 was used by our discontinued operation at Vital Pharma. Investing activities provided \$400,000 of net proceeds from the sale of Vital Pharma's assets and \$1.2 million net proceeds on the sale of Vital Pharma's real estate which was offset by \$3.3 million used for capital expenditures. Financing activities used \$10.5 million, consisting of \$7.6 million for the repurchase of common stock, \$1.5 million used to pay down an Industrial Revenue Bond, and \$2.3 million paid for dividends, offset by \$1.1 million of cash received from the exercise of stock options.

Cash and cash equivalents were \$72.5 million at June 30, 2004 as compared to \$55.7 million at September 30, 2003. At June 30, 2004 our working capital was \$108.1 million as compared to \$98.5 million at September 30, 2003. At June 30, 2004 the current ratio was 8.1 to 1, as compared to 6.5 to 1 at September 30, 2003.

Capital expenditures for the nine month period ended June 30, 2004 were approximately \$3.7 million, and included expenditures for equipment used as part of cost improvement projects at our New Jersey facility (\$600,000), Colorado facility (\$750,000), California facility (\$90,000) and Thomas Medical Products facility (\$240,000), machinery and equipment and tooling at Breas (\$873,000), new laboratory equipment (\$190,000) for the sleep labs at SSA, computer hardware and software to upgrade MIS systems (\$443,000) and the capitalized costs of software development (\$421,000) and patents (\$86,000). We expect that our total capital expenditures for fiscal 2004 should not exceed our total capital

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spending of \$4.6 million in fiscal 2003. This statement represents a forward-looking statement under the Reform Act. Actual results may differ from this statement for a number of reasons, including the possibility that the Company determines that its business requires new equipment in order to meet competitive and/or technological challenges.

Our current policy is to retain working capital and earnings for use in our business, subject to the payment of certain cash dividends. Such funds may be used for business acquisitions, product acquisitions, and product development, among other things. We regularly evaluate and negotiate with domestic and foreign medical device companies regarding potential business or product line acquisitions, licensing arrangements and strategic alliances.

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Our Board of Directors has authorized the expenditure of up to \$20 million for the repurchase of Vital Signs' stock. In fiscal 2003 and for the nine months ended June 30, 2004, we had repurchased 358,700 shares for \$10.2 million, at an average price of \$28.43. Any purchases under Vital Signs' stock repurchase program may be made from time-to-time in the open market, through block trades or otherwise. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time or from time-to-time without prior notice.

Our Board of Directors has approved \$2.3 million in dividends (amounting to \$.18 per share) in the current fiscal year.

Critical Accounting Principles and Estimates

We have identified the following critical accounting principles that affect the more significant judgments and estimates used in the preparation of our consolidated financial statements. The preparation of our consolidated financial statements in conformity with generally accepted accounting principles requires us to make estimates and judgments that affect our reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to asset impairment, revenue recognition, allowance for doubtful accounts, and contingencies and litigation. These estimates are based on the information that is currently available to us and on various other assumptions that we believe to be reasonable under the circumstances. We state these accounting policies in the notes to our consolidated financial statements and at relevant places in this discussion and analysis. Actual results could vary from these estimates under different assumptions or conditions.

We believe that the following critical accounting principles affect the more significant judgments and estimates used in the preparation of our consolidated financial statements:

- o Through September 30, 2001, we amortized goodwill and intangibles on a straight-line basis over their estimated lives. Upon our adoption of SFAS No. 142 on October 1, 2001, we ceased amortizing goodwill and we perform an annual impairment analysis based upon discounted cash flows to assess the recoverability of the goodwill, in accordance with the

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provisions of SFAS No. 142. We completed this impairment test during the three-month period ended June 30, 2004 and found no impairment. If we are required to record impairment charges in the future, it would have an adverse impact on our results of operations and financial condition.

- o We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments, which results in bad debt expense. Our allowance for doubtful accounts was \$600,000 at June 30, 2004 and \$919,000 at September 30, 2003. We determine the adequacy of this allowance by evaluating individual customer receivables, considering the customer's financial condition and credit history and analyzing current economic conditions. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.
- o Our sales to U.S. distributors are made at our established distributor price. Since the end-user (i.e., a hospital) is typically entitled, on a case by case basis, to a price lower than our established price, the distributor is due a rebate -- the difference between the established price and the lower price to which the end-user is entitled -- when shipment is made to the end user. In order to properly reflect our sales to distributors, we record the gross sale (at our established price), less the amount of expected rebate to arrive at net sales. This net sale is the amount we expect to receive in cash from the distributor on the sale.

On a monthly basis, each distributor provides us with documentation of shipment to particular end-users and computes a rebate on such shipments. Once the distributor has provided us with this information, they will deduct the computed rebate from their next remittance.

The amount of estimated rebate that has not yet been claimed by the distributor through the reduction of a payment is included in the allowance for rebates, which reduces the accounts receivable on our balance sheet. This allowance is calculated by adding (1) the amount of rebates the distributors have documented is due but not yet claimed and (2) an estimate of the amount of future rebates due on any inventory the distributors are holding at the end of each period.

For several years, we utilized an historical moving average calculation (comparing rebates to sales to distributors) in order to estimate the amount of rebate expense that should be recorded against gross sales in each period. Based upon a review conducted in connection with the filing of our Quarterly

Report on Form 10-Q for the quarter ended March 31, 2003, we concluded that our estimated allowance as calculated in the previous paragraph was greater than previously calculated. As a result of its review of the rebate allowance, we recorded an additional allowance for rebates of \$3,300,000 in the second quarter of fiscal 2003. We have continued

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to monitor the recorded allowance for rebates as well as the payments made against this estimate and believe we are providing a better estimate of the ultimate rebate our distributors are entitled to. The allowance for rebates was \$8,192,000 and \$6,156,000 at June 30, 2004 and September 30, 2003, respectively. Rebate expense was \$12,445,000 and \$10,911,000 for the three months ended June 30, 2004 and June 30, 2003, and was \$35,199,000 and \$33,436,000 for the nine months ended June 30, 2004 and June 30, 2003.

- o We have established an allowance for inventory obsolescence. The allowance was determined by performing an aging analysis of the inventory; based upon this review, inventory is stated at the lower of cost (first in, first out method) or its net realizable value. In the quarter ended June 30, 2004, the Company wrote-off certain Breas inventory amounting to \$363,000. Our inventory allowance for obsolescence was \$965,000 at June 30, 2004 and \$981,000 at September 30, 2003.
- o We are subject to various claims and legal actions in the ordinary course of our business. These matters frequently arise in disputes regarding the rights to intellectual property, where it is difficult to assess the likelihood of success and even more difficult to assess the probable ranges of recovery. Although we currently are not aware of any legal proceeding that is reasonably likely to have a material adverse effect on our financial position and results of operations, if we become aware of any such claims against us, we will evaluate the probability of an adverse outcome and provide accruals for such contingencies as necessary.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risks, including the impact of material price changes and changes in the market value of our investments and, to a lesser extent, interest rate changes and foreign currency fluctuations. In the normal course of business as described below, we employ policies and procedures with the objective of limiting the impact of market risks on earnings and cash flows and to lower our overall borrowing costs.

The impact of interest rate changes is not material to our financial condition. We do not enter into interest rate transactions for speculative purposes.

Our international net revenue represents approximately 26.3% of our total net revenues. Our Breas subsidiary, located in Sweden, represents 59.3% of our total international net revenues. We do not enter into any derivative transactions, including foreign currency transactions, for speculative purposes. The Company has not entered into any derivative instrument transactions (i.e. foreign exchange forward or option contracts) as of June 30, 2004.

Our risk involving price changes relate to raw materials used in our operations. We are exposed to changes in the prices of resins and latex for the manufacture of our products. We do not enter into commodity futures or

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derivative instrument transactions. Except with respect to our single source of supply for facemasks, it is our policy to maintain commercial relations with multiple suppliers and when prices for raw materials rise to attempt to source alternative supplies.

Item 4. Controls and Procedures

(a) Disclosure controls and procedures. As of the end of the Company's most recently completed fiscal quarter covered by this report, the Company carried out an evaluation, with the participation of the Company's management, including the Company's Chief Executive Officer and Interim Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-15. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms.

(b) Changes in internal controls over financial reporting. There have been no changes in the Company's internal controls over financial reporting that occurred during the Company's last fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings:

(a) On December 8, 1999, a complaint was filed against us on behalf of the former shareholders of our Vital Pharma subsidiary alleging breach of contract for failure to pay earnout payments allegedly due under the stock purchase agreement executed in connection with our purchase of Vital Pharma in December 1995. In August 2000, the court ordered the plaintiff to submit their claims to binding arbitration and stayed all other proceedings pending the outcome of the arbitration. The arbitration hearing commenced on January 26, 2004. The hearing is being held on an intermittent schedule and the presentation of testimony is expected to be concluded during the fourth quarter of the current fiscal year.

(b) On May 7, 2003 a complaint was filed against the Company and two of its officers by Joseph Bourgart, a former chief financial officer of the Company. A detailed description of this litigation is set forth in Item 3, Legal Proceedings, of the Company's Annual Report on Form 10-K for the year ended September 30, 2003. The Company strongly denies all of Plaintiff's substantive allegations. On June 23, 2004 the Company announced that the litigation had been settled. Monetary terms of the settlement were not disclosed. However, the settlement was immaterial to the financial results of the Company and were fully reimbursed by the Company's insurance carrier.

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(c) A first amended complaint was filed against the Company's Vital Pharma subsidiary on September 8, 2003 in the U.S. District Court for the Northern District of California related to the packaging services it provides to Lifecore Biomedical, Inc. ("Lifecore"). The complaint also names Lifecore and Ethicon, Inc. (a subsidiary of Johnson and Johnson) as defendants. A detailed description of this litigation is set forth in Item 3, Legal Proceedings, of the Company's Annual Report on Form 10-K for the year ended September 30, 2003. The Company's insurance carrier has responded and has also notified Lifecore of its obligation under its agreement with Vital Pharma to indemnify it for complaints related to product defects.

On January 28, 2004 plaintiff filed a nearly identical lawsuit in California state court on her own behalf and on behalf of the general public alleging violation of the California Business and Professions Code based upon the facts underlying the federal court action. Our insurance carrier has denied coverage for this matter. The Company has notified Lifecore of its obligations to defend and indemnify the Company for these claims.

(d) On May 16, 2003 the Company was served with a complaint by a former Belgian distributor for breach of contract. The distributor and the Company have entered into a settlement agreement. The settlement amount is within the reserve amount established by the Company for the litigation.

(e) A detailed description of litigation involving the Company is set forth in Item 3, Legal Proceedings, of the Company's Annual Report on Form 10-K for the year ended September 30, 2003. We are also involved in other legal proceedings arising in the ordinary course of business. We cannot predict the outcome of our legal proceedings with certainty. However, based upon our review of pending legal proceedings, we do not believe the ultimate disposition of our pending legal proceedings will be material to our financial condition. Predictions regarding the impact of pending legal proceedings constitute forward-looking statements. The actual results and impact of such proceedings could differ materially from the impact anticipated, primarily as a result of uncertainties involved in the proof of facts in legal proceedings.

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Item 2. Changes in Securities and Use of Proceeds:

The following table provides information about purchases made by the Company of its common stock during the quarter ended June 30, 2004:

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid Per Share | (c) (1) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maxim Amou May Purc Unde Plans or |
|--------|--|---|---|---|
| ----- | ----- | ----- | ----- | ----- |
| | | | | |

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| | | | | |
|-------------------------|---------|---------|---------|--------|
| 4/1/2004-4/30/2004..... | -- | -- | -- | \$13,6 |
| 5/1/2004-5/31/2004..... | 38,500 | \$27.45 | 38,500 | \$12,5 |
| 6/1/2004-6/30/2004..... | 102,600 | \$27.14 | 102,600 | \$9,7 |
| | ----- | ----- | ----- | ----- |
| Total..... | 141,100 | \$27.22 | 141,100 | \$9,7 |
| | ===== | ===== | ===== | ===== |

(1) In May 2003, our Board of Directors authorized the expenditure of up to \$20 million for the repurchase of Vital Signs' stock. During the nine months ended June 30, 2004, we had repurchased 258,400 shares for \$7.6 million, including commissions of \$10,336, at an average price of \$29.53. Any purchases under Vital Signs' stock repurchase program may be made from time-to-time in the open market, through block trades or otherwise. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time or from time-to-time without prior notice.

Item 3 (Not applicable)

Item 4. Submission of Matters to a Vote of Security Holders

The annual meeting of our shareholders was held on April 9, 2004. At that meeting, each of the nominees for election to the Board, as identified in our proxy statement, was elected. The Board of Directors nominated 3 directors whose terms will expire in 2007. The following number of shares was voted for and against each nominee:

| Nominee | Votes For | Authority Withheld |
|-------------------------|------------|--------------------|
| ----- | ----- | ----- |
| David H. MacCallum..... | 11,442,437 | 314,666 |
| Richard L. Robbins..... | 11,394,222 | 362,281 |
| George A. Schapiro..... | 11,473,271 | 283,232 |

Item 5. Other Information

Mr. Joseph J. Thomas, a Director of the Company and President of Thomas Medical Products, a subsidiary of the Company, has announced his intention to retire from the Company and as a Director effective October 1, 2004.

Item 6. Reports on Form 8-K (excluding reports furnished to, but not deemed filed with, the Commission) A Current Report on Form 8-K was filed on May 11, 2004, disclosing (under Item 5) the resignation as of May 10, 2004 of Frederick A. Schiff as Chief Financial Officer of the Company.

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EXHIBIT INDEX

Exhibits

- 31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Interim Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer Pursuant to [p] U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Interim Chief Financial Officer Pursuant to [p] U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

VITAL SIGNS, INC.

By: /s/ RICHARD T. FEIGEL

 Richard T. Feigel
 Corporate Controller and
 Interim Chief Financial Officer

Date: August 13, 2004

STATEMENT OF DIFFERENCES

The trademark symbol shall be expressed as 'TM'
 The paragraph symbol shall be expressed as [p]