SYNBIOTICS CORP
Form 10-K
March 31, 2003
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U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the year ended December 31, 2002

OR

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

Commission file number 0-11303

SYNBIOTICS CORPORATION

(Exact name of registrant as specified in its charter)

California	**95-3737816**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
11011 Via Frontera	
San Diego, California	**92127**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (858) 451-3771

Securities registered pursuant to Section 12(b) of the Exchange Act: None

Securities registered pursuant to Section 12(g) of the Exchange Act: Common Stock

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 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 filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and no disclosure will be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

The aggregate market value of the common stock held by non-affiliates of the registrant as of June 28, 2002 was approximately $1,909,000 based on the closing sale price as reported by the NASD over-the-counter bulletin board. Shares of common stock held by each officer, director and holder of 10% or more of the outstanding common stock, if any, have been excluded in that such persons may be deemed to be affiliates. this determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 28, 2003, there were 19,619,691 shares of our common stock outstanding.

The report of PricewaterhouseCoopers LLP, our former independent accountants, required by Item 8 related to our consolidated financial statements as of December 31, 2001 and 2000, and for each of the two years in the period ended December 31, 2001 and the consent of PricewaterhouseCoopers LLP required by Item 15(c) related to that report, have been omitted from this Form 10-K due to the inability of PricewaterhouseCoopers to provide us with those documents in a timely manner.

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SYNBIOTICS CORPORATION

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PART I

Item 1. Business

General

Synbiotics Corporation is a leading provider of rapid diagnostic and laboratory diagnostic products for the animal health care industry. We are one of a small number of companies that focuses exclusively on animal health and we are a major provider of diagnostic products to the animal health market. Our product portfolio consists of 96 diagnostic test kits and detection devices. Many of our products hold strong positions in their specific markets.

In 2002, we sold our instrument manufacturing operations, which were located in Rome, New York, and we disposed of our PennHIP® business, which was located in Malvern, Pennsylvania.

In 2001, we exited the veterinary vaccines business.

In April 2000, we acquired our poultry diagnostic products business.

In January 2000, we acquired W3COMMERCE, LLC, an Internet marketing services company operating in both the animal health industry and in other industries. After making a substantial investment in W3COMMERCE, we decided to exit the Internet services business and sold 84% of W3COMMERCE back to its original owners at the end of 2000.

Market and Product Overview

We sell our products both in the United States and in foreign countries. The total number of family owned dogs and cats is estimated to exceed 135 million in the United States alone. We believe that our current and intended future products will offer veterinarians an opportunity to improve the quality and expand the scope of veterinary health care services.

Our most commercially successful products are our canine heartworm diagnostics (representing 36%, of our net sales in 2002, 2001 and 2000, respectively). We estimate that we have approximately a 30% share of the estimated $30 million U.S. heartworm diagnostics market. Sales of these products have historically been strongest during the first half of the year when distributors purchase merchandise to sell to veterinarians for the heartworm season. Our vaccine business, which we exited in 2001, represented 1% and 17% of our net sales in 2001 and 2000, respectively.

Marketing

We sell our products in the United States, Canada, Europe, Asia and, to a limited extent, Latin America. In the United States, we market our line both directly and through independent distributors which, taken together, have approximately 90 outlets, 600 field sales representatives, and 200 telemarketing representatives covering the 25,000 veterinary clinics throughout the country. Sales to laboratories and other centralized facilities (approximately 50 in the U.S.) are handled directly. Outside the United States, we sell our small-animal products through distributors and on an original equipment manufacturer (OEM) basis, and our food-animal products directly to laboratories. We maintain a marketing and sales force, which trains distributor representatives, responds to technical inquiries, promotes products directly to veterinarians, laboratories and poultry producers, advertises and promotes products through direct mail and journal advertisements, and provides other marketing support functions.

Manufacturing

We manufacture most of our products at our facilities located in San Diego, California and Lyons, France. However, we rely on outside manufacturers for our WITNESS® canine heartworm and feline leukemia diagnostic products and our SCA 2000 products. Our WITNESS® canine heartworm and feline leukemia diagnostic products are licensed to us by their respective outside manufacturer.

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Patents and Trade Secrets

We believe that our proprietary technology is an important competitive factor in our business, and that protection of our intellectual property rights is a high priority. The basic hybridoma (the cell that produces the monoclonal antibody) technology is in the public domain and is therefore not patentable. However, numerous improvements, variations and applications of hybridoma technology may prove to be patentable. Considering the difficulty of enforcing any patent rights to such improvements, and the rapid advancements in the field, we generally seek, and will continue to seek, to protect our interests by treating our particular variations in the production of monoclonal antibodies as trade secrets. We also pursue, and intend to continue to aggressively pursue, protection for new products, new methodological concepts, and compositions of matter through the use of patents where obtainable. At present, we have been granted 13 U.S. patents and we have one U.S. patent pending.

Government Regulation

Most diagnostic test kits for animal health applications marketed in the U.S. require approval by the United States Department of Agriculture (USDA). Germany and Japan are the only foreign countries in which we market our diagnostic products that require governmental approval for animal diagnostic products. Our instrumentation products are not subject to USDA regulation. Our canine semen freezing products and canine ovulation timing diagnostic products fall within the definition of devices as that term is defined in the Federal Food, Drug, and Cosmetic Act and, therefore, may be subject to regulation by the FDA.

Our manufacturing facilities in San Diego and Lyons, France are licensed by the USDA and adhere to Good Manufacturing Practices (GMP) standards. Our French manufacturing facility, which is ISO 9002 certified, is not licensed by any foreign regulatory agency as there is no licensing requirement. The manufacturing facilities of our important suppliers are subject to licensing and regulatory approval in both the United States and Europe.

In addition to the foregoing, our operations may be subject to future legislation and/or rules issued by domestic or foreign governmental agencies with regulatory authority relating to our business.

Competition

We are a major provider of diagnostic products to the animal health market. Most of our competitors are either small divisions of larger human health and chemical companies or smaller companies that sell veterinary products while trying to diversify into the higher profile, and more regulated, human health field. The principal competitor in the industry is IDEXX Laboratories, Inc., a publicly traded company with annual revenues of $412,000,000 (for 2002) that develops, manufactures, and distributes detection and diagnostic products for animal health, food, and environmental testing applications.

The market for animal health care products is extremely competitive. Companies in the animal health care market compete to develop new products, to market and manufacture products efficiently, to implement effective research strategies, and to obtain regulatory approval. Our current competitors include IDEXX Laboratories, a significantly larger company, and Heska Corporation. These companies have greater financial, manufacturing, marketing, and research resources than we do. In addition, IDEXX Laboratories prohibits its distributors from selling

competitors products, including ours. Further, additional competition could come from new entrants to the animal health care market. We cannot assure you that we will be able to compete successfully in the future or that competition will not harm our business.

Research and Development

We spent approximately $1,380,000 and $1,604,000 on research and development activities during the years ended December 31, 2002 and 2001, respectively. These figures include both internal research and development and expenditures under contracts for research and development activities with outside parties relating to certain veterinary diagnostic products which utilize licensed technology.

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Employees

As of December 31, 2002, we had a total of 94 employees worldwide, 91 of whom were full-time.

Raw Materials

The manufacturing of diagnostics and diagnostic instruments requires raw materials which generally are, and have been, readily available from several sources.

Financial Information About Industry Segments and Financial Information About Foreign and Domestic Operations and Export Sales

See Note 16 to our financials statements in Item 8 of Part II of this Form 10-K.

Item 2. Properties

We lease two buildings in San Diego, California. The buildings contain approximately 42,000 square feet of space, and house our corporate and sales headquarters, executive offices, U.S. research and development laboratories and manufacturing facilities. We also lease an approximately 25,000 square foot building in Lyons, France which houses Synbiotics Europe s (SBIO-E) corporate and sales headquarters, executive offices, research and development laboratories and manufacturing facilities. In addition, we lease a sales office in Kansas City, Missouri and a research office in College Park, Maryland.

We believe that these facilities are adequate for our current level of operations.

Item 3. Legal Proceedings

Synbiotics Corporation v. Heska Corporation United States District Court for the Southern District of California

In November 1998, Synbiotics Corporation filed a lawsuit against Heska Corporation in the United States District Court for the Southern District of California alleging that Heska infringed a patent owned by Synbiotics relating to heartworm diagnostic technology. In March 2003, Synbiotics and Heska entered into settlement and license agreements which have resolved all outstanding claims in the lawsuit. As part of those

agreements, each party has licensed certain intellectual property rights from the other party, including Heska licensing from Synbiotics the patent relating to the heartworm diagnostic technology.

MTrade Comercio Importacao E Exporta, a Brazilian corporation, vs. Synbiotics Corporation San Diego County Superior Court

On August 3, 2001, MTrade Comercio Importacao E Exporta, a Brazilian corporation, (MTrade) filed a lawsuit against us alleging a breach of contract related to a distribution agreement for certain of our products which we terminated due to MTrade s lack of performance under the agreement. In January 2002, MTrade withdrew its complaint, and re-filed the complaint in March 2002. In February 2003, the Court granted our motion for summary judgment, and the lawsuit was dismissed in its entirety.

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

None.

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PART II

Item 5. Market for Registrant s Common Equity and Related Stockholder Matters

Our common stock is quoted in the NASD over-the-counter bulletin board under the symbol SBIO. Price ranges reported are the high and low sale price information as reported by the NASD over-the-counter bulletin board. Such market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not represent actual prices. No cash dividends have ever been paid on our common stock, and we do not anticipate paying cash dividends on our common stock in the foreseeable future. As of March 28, 2003, there were approximately 570 shareholders of record of our common stock.

Year	Quarter	High	Low
2001	1st Quarter	$ 0.88	$ 0.38
	2nd Quarter	$ 0.70	$ 0.23
	3rd Quarter	$ 0.42	$ 0.12
	4th Quarter	$ 0.34	$ 0.13
2002	1st Quarter	$ 0.45	$ 0.18
	2nd Quarter	$ 0.30	$ 0.10
	3rd Quarter	$ 0.22	$ 0.13
	4th Quarter	$ 0.15	$ 0.04

We have never paid cash dividends on our common stock and do not expect to do so in the foreseeable future. In addition, the terms of our bank loan and of our Series C preferred stock restrict our ability to pay any cash dividends on our common stock.

Item 6. Selected Financial Data

	Year Ended December 31,				
	2002	2001	2000	1999	1998
	(In Thousands, Except Per Share Data)				
Consolidated Statement of Operations Data:					
Total revenues	$ 21,671	$ 26,532	$ 29,738	$ 29,576	$ 31,009
(Loss) income from continuing operations	(6,862)	626	(13,193)	(820)	(1,469)
Net (loss) income	(14,401)	431	(18,518)	(1,566)	(1,911)
Basic (loss) income per share:					
(Loss) income from continuing operations	(0.48)	0.06	(1.43)	(0.10)	(0.18)
Net (loss) income	(1.00)	0.04	(2.00)	(0.19)	(0.23)
Diluted (loss) income per share:					
(Loss) income before extraordinary item	(0.48)	0.06	(1.43)	(0.10)	(0.18)
Net (loss) income	(1.00)	0.04	(2.00)	(0.19)	(0.23)

	December 31,

	2002	2001	2000	1999	1998
			(In Thousands)		
Consolidated Balance Sheet Data:					
Total assets	$ 15,436	$ 26,502	$ 32,202	$ 44,531	$ 45,930
Long-term obligations	6,478	10,943	7,508	10,356	10,856

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

The information contained in this Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Annual Report on Form 10-K contains both historical financial information and forward-looking statements. Forward-looking statements are characterized by words such as intend , plan , believe , will , would , etc. Historical financial information may not be indicative of future financ performance. In fact, future financial performance may be materially different than the historical financial information presented herein. Moreover, the forward-looking statements about future business or future results of operations are subject to significant uncertainties and risks, including those detailed under the caption Certain Risk Factors , which could cause actual future results to differ materially from what is suggested by the forward-looking information.

Results of Operations

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001

Our net sales for the year ended December 31, 2002 decreased by $4,143,000 or 16% from the year ended December 31, 2001. The decrease reflects a decrease in our diagnostic product sales of $4,012,000 primarily related to canine heartworm diagnostic products. Sales of our diagnostic products decreased due to the loss of one of our larger distributors in January 2002 who accounted for $1,617,000 of our sales in the year ended December 31, 2001, an additional $599,000 related to the fourth quarter 2001 transfer of our Japanese diagnostic business to a third party as part of a license agreement, and increased competition in the canine heartworm market. The increased competition in the canine heartworm market resulted from IDEXX Laboratories combination in-clinic diagnostic test. In addition, our sales in France for the year fell by $635,000 or 26% due primarily to the French authorities decisions to no longer require cattle to be tested annually for tuberculosis.

We recognize revenue from product sales when title and risk of loss transfers to our customer, which is generally upon shipment. Amounts we charge to our customers for shipping and handling are included in our net sales. We provide promotional discounts and rebates to certain of our distributors. Based upon the structure of these rebate programs and our past history, we are able to accurately estimate the amount of rebates at the time of sale. These rebates are recorded as a reduction of our net sales. We recognize license fee revenue ratably over the license term when we have further performance obligations to our licensee. In the event that we have no further performance obligations to our licensee, we recognize license fee revenue upon receipt.

Our cost of sales as a percentage of our net sales was 49% during the year ended December 31, 2002 compared to 45% during the year ended December 31, 2001. The lower gross margins are a direct result of the decrease in our sales during the year ended December 31, 2002, and the fact that a significant portion of our manufacturing costs are fixed.

Among our major products, our DiroCHEK® canine heartworm diagnostic products are manufactured at our facilities, whereas our WITNESS® canine heartworm and feline leukemia diagnostic products and the SCA 2000 products are manufactured by third parties. Our poultry diagnostic products were manufactured for us by a third party during 2001. In addition to affecting our gross margins, outsourcing of manufacturing renders us relatively more dependent on the third-party manufacturers.

We completed the transfer of the manufacturing of our poultry diagnostic products from our supplier to our manufacturing facilities in San Diego during the first quarter of 2002, although some of the lower-volume products are awaiting licensure by the USDA. We believe that our gross margins on these products will improve as we will have more products to absorb our fixed manufacturing costs.

Our research and development expenses decreased by $224,000 or 14% during the year ended December 31, 2002 as compared to the year ended December 31, 2001. The decreases are due primarily to the decrease in research activities performed for us by third parties, and decreases in patent legal expense. Our research and development expenses as a percentage of our net sales were 6% during the years ended December 31, 2002 and 2001.

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Our selling and marketing expenses decreased by $1,306,000 or 23% during the year ended December 31, 2002 as compared to the year ended December 31, 2001. The decreases are due to a concerted effort to reduce selling and marketing expenses. Our selling and marketing expenses as a percentage of our net sales were 20% and 22% during the years ended December 31, 2002 and 2001, respectively.

Our general and administrative expenses increased by $2,526,000 or 40% during the year ended December 31, 2002 as compared to the year ended December 31, 2001. The increase is primarily due to $3,682,000 of retention bonuses that became payable upon the consummation of the January 2002 Redwood preferred stock investment transaction, the severance costs related to the July 2002 termination of the President of SBIO-E and the September 2002 resignations of our Chief Executive Officer and Chief Financial Officer, and offset by the fact that goodwill is no longer amortized. Our general and administrative expenses as a percentage of our net sales were 41% and 24% during the year ended December 31, 2002 and 2001, respectively. Excluding the first quarter 2002 bonus expense and the goodwill amortization during the year ended December 31, 2001, our general and administrative expenses would have been $5,090,000 and $4,801,000 during the years ended December 31, 2002 and 2001, respectively, or 24% and 19% of our net sales during the years ended December 31, 2002 and 2001, respectively.

Our net interest expense decreased by $268,000 or 29% during the year ended December 31, 2002 as compared to the year ended December 31, 2001. The decreases are due to the decrease in the prime rate during 2002 and 2001, and decreases in the outstanding principal balance of our bank loan.

We recognized a provision for income taxes of $7,000 during the year ended December 31, 2002 as compared to a provision for income taxes of $10,000 during the year ended December 31, 2001. The change in our ownership resulting from the January 2002 Redwood transaction limits the utilization of both Federal and state net operating loss carryforwards to $59,000 per year. As a result of this limitation, $15,999,000 of our Federal net operating loss carryforwards, and $969,000 of our state net operating loss carryforwards, may expire before they can be utilized.

Cash was extremely tight for us throughout 2001 and into 2002, and at times we were on credit hold with several of our key suppliers. Our lack of liquidity may have had a detrimental impact on our business in 2001 and 2002. It is unclear whether any impact on our business would continue into 2003. However, due to the scheduled December 2002 payout of $406,000 of cash retention bonuses and the decrease in our sales during the year ended December 31, 2002, cash is again tight for us. As a result, at the end of the third quarter of 2002, we began implementing a cost reduction program, which included a reduction in our headcount.

We disposed of two unprofitable business lines in 2002. In August 2002, we sold our instrument manufacturing operations, located in Rome, New York, to Danam Acquisition Corp., located in Dallas, Texas, in exchange for a $500,000 note receivable. The note is payable, beginning in September 2002, in 60 monthly principal payments of $8,000 plus interest at 5%, is secured by the assets of the disposed operations (all of which we had been previously written off), and is guaranteed by Drew Scientific Group PLC (the parent of Danam Acquisition Corp.) In November 2002, we terminated the license agreement for our PennHIP® operations, located in Malvern, Pennsylvania, and transferred all of the assets related to the PennHIP® operations to the University of Pennsylvania. No consideration was received for the transferred assets. We recorded the $500,000 sale price for the instrument manufacturing operations in, and we have restated prior amounts related to the disposed operations as, discontinued operations. See Note 4 to our consolidated financial statements in Item 8 for a reconciliation of the restated amounts for the years ended December 31, 2001 and 2000.

As of January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142 (FAS 142), Goodwill and Other Intangible Assets . FAS 142 changed the accounting for goodwill from an amortization method to an impairment-only approach. Under FAS 142, goodwill is tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. Upon adoption of FAS 142, amortization of

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goodwill recorded for business combinations consummated prior to July 1, 2001 ceased. In connection with the adoption of FAS 142, we performed a transitional goodwill impairment assessment. As a result of this impairment assessment, we recorded an impairment of $7,756,000 which is classified as a cumulative effect of a change in accounting principle in the first quarter of 2002. We will perform subsequent impairment assessments, at a minimum, in the fourth quarter of each year; and subsequent impairments, if any, will be classified as an operating expense. Our measurement of fair value upon adoption of FAS 142 was based upon a fairness opinion prepared by an independent investment advisor in conjunction with the Redwood transaction. Our measurement of fair value for subsequent impairment assessments will be the market price of our common stock on the date the assessment is performed. As a result of decreases in the market price of our common stock during 2002, we recorded an impairment loss of $2,877,000 in the fourth quarter of 2002.

As of January 1, 2002, we adopted Statement of Financial Accounting Standards No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144). FAS 144 supersedes FAS 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of . FAS 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30 (APB 30), Reporting Results of Operations Reporting the Effects of Disposal of a Segment of a Business . FAS 144 develops one accounting model for long-lived assets that are to be disposed of by sale. FAS 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, FAS 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. The adoption of FAS 144 did not have a material impact on our financial position or results of operations.

Year Ended December 31, 2001 Compared to Year Ended December 31, 2000

Our net sales for the year ended December 31, 2001 decreased by $3,977,000 or 13% from the year ended December 31, 2000. The decrease reflects a decrease in our sales of vaccine products of $4,664,000, an increase in our diagnostic product sales of $1,036,000 and a decrease in our instrument product sales of $349,000. The decrease in our vaccine sales is due solely to Intervet s inability to supply us with FeLV vaccine, resulting in our decision on June 1, 2001 to exit the vaccine business. Our increase in diagnostic sales is due primarily to an increase in sales of our canine heartworm diagnostic products of $2,038,000 and an increase in our sales of poultry diagnostic products of $180,000, which we acquired in April 2000, offset by an increase in performance rebates earned by distributors during 2001 of $1,134,000. The increased sales of our canine heartworm diagnostic products are due to increased sales by our distributors, resulting from our working more closely with them and utilizing unique and aggressive promotional programs such as the Witness® Challenge. The increase in our sales of poultry diagnostic products was a result of having a full year of sales in 2001 compared to less than nine months in 2000, but 2001 sales were hurt by manufacturing problems at our supplier, which resulted in a June 2001 recall of substantially all of our poultry diagnostic products. Our instrument product sales decreased primarily due to a decrease in new unit placements during 2001, offset by an increase in sales of reagents for the instruments. We recognize revenue from product sales when title and risk of loss transfers to our customer, which is generally upon shipment. Amounts we charge to our customers for shipping and handling are included in our net sales. We provide promotional discounts and rebates to certain of our distributors. Based upon the structure of these rebate programs and our past history, we are able to accurately estimate the amount of rebates at the time of sale. These rebates are recorded as a reduction of our net sales. We recognize license fee revenue ratably over the license term when we have further performance obligations to our licensee. In the event that we have no further performance obligations to our licensee, we recognize license fee revenue upon receipt.

On June 1, 2001, we assigned our FeLV vaccine distribution agreement with Intervet to Merial Limited, Merial S.A.S. and Merial, Inc. (collectively Merial). In exchange, Merial waived its right to sell back to us 621,000 shares of our common stock at $5.00 per share (the Put Right). Merial also agreed to allow us to pay accrued royalties totalling $613,000 under a separate agreement ($175,000 of which was due in May 2001 and

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the remainder of which was due in October 2001) in ten monthly installments of $61,300 which began in July 2001. If we failed to meet our royalty payment obligation, the Put Right would have reverted to Merial. When the final royalty payment was made in April 2002, and the Put Right was extinguished, we reclassified the mandatorily redeemable common stock to shareholders equity.

In March 1999, we amended our U.S. FeLV vaccine supply agreement with Merial, and we received $1,453,000 which we were recognizing as license fee revenue over the remaining life of the supply agreement. Because we assigned our distribution agreement with Intervet to Merial, we have no further contractual obligations under the supply agreement and we recognized, in June 2001, the remaining $868,000 of deferred license fee revenue. Our vaccine sales totalled $4,968,000 and $6,013,000 during 2000 and 1999, respectively, of which $1,500,000 and $1,040,000 was sold to Merial in France in 2000 and 1999, respectively.

Our cost of sales as a percentage of our net sales was 45% during the year ended December 31, 2001 compared to 52% during the year ended December 31, 2000. The higher gross margins are a direct result of these factors:

- the decreased vaccine sales which have historically had low margins, and
- increased sales of our poultry diagnostic products which have significantly higher margins.

Our research and development expenses decreased by $137,000 or 8% during the year ended December 31, 2001 as compared to the year ended December 31, 2000. The decrease is due primarily to decreases in patent legal expenses commensurate with reduced patent filing activities. Our research and development expenses as a percentage of our net sales were 6% during the years ended December 31, 2001 and 2000, respectively.

Our selling and marketing expenses decreased by $3,174,000 or 36% during the year ended December 31, 2001 as compared to the year ended December 31, 2000. The decrease is due primarily to the disposition of W3COMMERCE (our Internet marketing services subsidiary) at the end of 2000, the termination of our direct-to-veterinarian telemarketing group during the third quarter of 2000 and a concerted effort to reduce our print media advertising. Our selling and marketing expenses as a percentage of our net sales were 22% and 30% during the years ended December 31, 2001 and 2000, respectively.

Our general and administrative expenses during the year ended December 31, 2001 did not change significantly from the year ended December 31, 2000. Our general and administrative expenses as a percentage of our net sales were 24% and 21% during the years ended December 31, 2001 and 2000, respectively.

Our net interest expense decreased by $407,000 or 30% during the year ended December 31, 2001 as compared to the year ended December 31, 2000, due to decreases in the prime rate during 2001, as well as the fact that our $2,813,000 convertible note payable to W3COMMERCE was extinguished on January 1, 2001 in conjunction with our sale of 84% of our investment in W3COMMERCE.

We recognized a provision for income taxes of $10,000 during 2001 as compared to a provision for income taxes of $8,715,000 during 2000. The change is primarily due to permanent differences between income for financial reporting purposes and tax reporting purposes in 2000 related to impairment losses, and an increase in our deferred tax asset valuation allowance in 2000 of $9,372,000.

In 2002, we disposed of our instrument manufacturing operations located in Rome, New York and our PennHIP® business located in Malvern, Pennsylvania. We have reclassified all revenues and expenses associated with these disposed operations to discontinued operations for the years ending December 31, 2001 and 2000. Our loss on discontinued operations, net of tax, decreased by $4,532,000 or 96% during the year ended December 31, 2001 as compared to the year ended December 31, 2000, and is due primarily to impairment losses of $3,000,000 recognized in 2000 related to the goodwill and other long-lived assets associated with the instrument manufacturing operations located in Rome, New York.

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Year Ended December 31, 2000 Compared to Year Ended December 31, 1999

Our net sales for the year ended December 31, 2000 increased $165,000 or 1% over the year ended December 31, 1999. The increase reflects an increase in our diagnostic product sales of $558,000 and an increase in our instrument product sales of $652,000, while sales of our vaccine products decreased $1,045,000. The increase in our sales of diagnostic products is primarily due to sales of the KPL poultry diagnostic products which we acquired in April 2000, offset by the effect of aggressive promotional discounts in the United States during the first quarter of 2000 which attempted to respond to increased competition in the canine heartworm diagnostic market. While our canine heartworm diagnostic sales in units increased, these sales were at reduced average selling prices. Our U.S. heartworm sales in units during the first half of 2000 increased by 6% over the first half of 1999, yet our sales in dollars for these products decreased by 17%. In Europe, sales of our large animal diagnostic products decreased due to increased competition, and a change in the timing of mandated disease eradication testing required by certain European governmental authorities. Tests that used to be required annually are now only required to be performed every other year. The weakening of the French franc against the U.S. dollar also negatively impacted our reported European diagnostic sales. Our instrument product sales increased due to a full year s worth of sales of our SCA 2000 blood coagulation timing instrument, which we introduced during the second quarter of 1999. Our decreased vaccine sales reflects the absence of sales of vaccines to private label partners which we discontinued during the third quarter of 1999 because we were unable to obtain a supply of a crucial manufacturing material, as well as Intervet s inability to manufacture FeLV vaccine at the end of 2000 with which we could have filled Merial s orders. At the end of 2000 there were backorders of $1,200,000 for FeLV vaccine for shipment to Merial in Europe.

All of our vaccine products (exclusive of our FeLV vaccine products) were manufactured using bulk antigen fluids that were supplied by a third party. The supply agreement expired and we were unable to locate a replacement supplier for these bulk antigen fluids. We decided to discontinue the sales of the affected products once our remaining supplies were exhausted, which occurred during the third quarter of 1999. Sales of the affected products totaled $1,645,000 and $2,073,000 during 1999 and 1998, respectively.

Our cost of sales as a percentage of our net sales was 52% during the years ended December 31, 2000 and 1999. Our gross margins are restrained by the fact that a significant portion of our manufacturing costs are fixed costs. Among our major products, our DiroCHEK® canine heartworm diagnostic products are manufactured at our facilities, whereas our WITNESS® canine heartworm and feline leukemia diagnostic products, our poultry diagnostic products, and the SCA 2000 products were manufactured by third parties. In addition to affecting our gross margins, outsourcing of manufacturing renders us relatively more dependent on the third-party manufacturers.

Our research and development expenses during the year ended December 31, 2000 did not change significantly from the year ended December 31, 1999. Our research and development expenses as a percentage of our net sales were 6% during the years ended December 31, 2000 and 1999, respectively.

Our selling and marketing expenses during the year ended December 31, 2000 increased by $2,410,000 or 37% over the year ended December 31, 1999. The increase is due primarily to the results of our internet marketing efforts through W3COMMERCE (which we acquired in January 2000) and an increase in our direct-to-veterinarian telemarketing group. The disappointing results related to W3COMMERCE were due to delays in execution of the business plan, a slowdown in e-business and our lack of resources to fully fund W3COMMERCE s efforts. Our selling and marketing expenses as a percentage of our net sales were 30% and 22% year ended December 31, 2000 and 1999, respectively. At the end of the third quarter of 2000, we refocused our sales and marketing efforts towards traditional animal health distribution and, as a result, we significantly reduced the headcount of our telesales force. In addition, at the end of December 2000, we agreed to sell 84% of our investment in W3COMMERCE back to its original owners.

Our general and administrative expenses during the year ended December 31, 2000 increased by $394,000 or 7% over the year ended December 31, 1999. The increase is due primarily to legal expenses related to our

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patent litigation with Heska, increased goodwill amortization related to our KPL acquisition, and foreign currency losses related to our intercompany receivable from Synbiotics Europe. Our general and administrative expenses as a percentage of our net sales were 21% and 19% during the years ended December 31, 2000 and 1999, respectively.

Our net interest expense during 2000 increased $192,000 or 17% over 1999 due to an increase in our borrowings.

During 2000, we recognized an impairment loss totalling $986,000 related to our investment in W3COMMERCE, which we sold 84% of back to its original owners at the end of 2000.

We recognized a provision for income taxes of $8,715,000 during 2000 as compared to a benefit from income taxes of $182,000 during 1999. The change is primarily due to permanent differences between income for financial reporting purposes and tax reporting purposes related to the impairment loss discussed above, and an increase in our deferred tax asset valuation allowance of $9,372,000. As a result of our liquidity concerns, continuing net losses and alternative strategies for the business, we believe that it is more likely than not that our deferred tax assets will not be realized in the future.

In 2002, we disposed of our instrument manufacturing operations located in Rome, New York and our PennHIP® business located in Malvern, Pennsylvania. We have reclassified all revenues and expenses associated with these disposed operations to discontinued operations for the years ending December 31, 2000 and 1999. Our loss on discontinued operations, net of tax, increased by $3,853,000 or 440% during the year ended December 31, 2000 as compared to the year ended December 31, 1999, and is due primarily to impairment losses of $3,000,000 recognized in 2000 related to the goodwill and other long-lived assets associated with the instrument manufacturing operations located in Rome, New York.

Financial Condition and Liquidity

In January 2002, we issued 2,800 shares of Series B preferred stock to Redwood West Coast, LLC (Redwood), in exchange for $2,800,000 cash. Without this investment, we would not have had the working capital necessary to continue our business. The Series B preferred shares were convertible into an aggregate of 21,797,000 shares of our common stock, were entitled to quarterly cumulative dividends at a 7.5% annual rate and were entitled to an aggregate liquidation preference of $2,800,000 plus accumulated and unpaid dividends. The Series B preferred stock defined a merger and/or acquisition as a liquidating event; and as a result, the Series B preferred stock were considered to be mandatorily redeemable and were classified outside of permanent shareholders equity on the balance sheet.

In October 2002, we designated and authorized 4,000 shares of Series C preferred stock, and entered into a stock swap agreement with Redwood whereby we issued 2,800 shares of Series C preferred stock to Redwood in exchange for Redwood s 2,800 shares of Series B preferred stock. The Series C preferred stock is entitled to quarterly cumulative cash dividends (although an election can be made to receive the dividends in shares of our common stock in the event the dividends are not paid within 30 days), at a 7.5% annual rate; the Series C preferred stock is additionally entitled to, in effect, the dividends which had accumulated on the Series B preferred stock before the exchange. The Series C preferred stock is entitled to an aggregate liquidation preference of $2,800,000, plus accumulated and unpaid dividends. Each share of Series C preferred stock is convertible into 7,785 shares of common stock (subject to anti-dilution adjustments). The Series C preferred stock does not define a merger and/or acquisition as a liquidating event; and as a result, the carrying amount of the Series C preferred stock will be classified as a part of permanent shareholders equity on the balance sheet.

Redwood representatives now constitute 67% of our board of directors, and Redwood also controls approximately 55% of our voting stock on a fully diluted basis.

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In conjunction with the Redwood transaction, and pursuant to selectively amended retention bonus agreements, we issued, on May 15, 2002, an aggregate of 8,255,000 shares of our common stock to certain employees. We also agreed to pay the employees income tax withholding obligation related to the stock retention bonuses in exchange for the cancellation of options outstanding for an aggregate of 880,000 shares of our common stock. In addition, we also amended cash retention bonus agreements with certain of our employees so that $653,000 that would have become payable upon the consummation of the Redwood transaction was instead payable no later than January 1, 2003, and was in fact paid in December 2002. In addition, under the employees cash retention bonus agreements, options to purchase an aggregate of 72,000 shares of our common stock became immediately vested upon consummation of the Redwood transaction, and the expiration date of the 72,000 stock options was extended to January 25, 2004. We recorded compensation expense in the first quarter of 2002 totalling $3,682,000 related to the retention bonuses.

We amended our credit agreement with Comerica Bank California (Comerica) in conjunction with the Redwood transaction. Without the amendment, we could not have repaid our indebtedness to Comerica when it came due. The $7,132,000 principal amount outstanding under our revolving line of credit and term note, each due in March 2002, was converted into a new $7,132,000 term note. The new note bears interest at the rate of prime plus 2%, and is payable in monthly installments of $100,000 plus accrued interest through January 2003 and monthly installments of $125,000 plus accrued interest thereafter, with all remaining principal due January 25, 2004. As of December 31, 2001, we were not in compliance with certain of the original Comerica financial covenants. The amended credit agreement waived all prior instances of non-compliance with financial covenants, and includes only minimal financial covenants for the future. We believe we will not be able to repay the amended Comerica note when it comes due in January 2004, and that we will have to restructure the note with Comerica or refinance it with another lending source, or obtain additional capital to facilitate the restructuring or refinancing of the bank debt.

The following table summarizes the future cash payments related to our contractual obligations as of December 31, 2002 (amounts are in thousands):

	Total	2003	2004	2005	2006	2007	Thereafter
Long-term debt	$ 5,991	$ 1,475	$ 4,516				
Operating leases	5,602	865	810	$ 829	$ 668	$ 426	$ 2,004
Other long-term obligations	2,500			1,000	1,500		

We believe that our present capital resources, including our working capital of $3,041,000 at December 31, 2002, as well as our anticipated cash from operations (including the effects of our cost reduction program), are insufficient to meet our working capital needs and meet our contractual obligations for at least the next twelve months, given that our bank loan is due within that twelve-month period. Aside from the bank loan, we believe our present working capital resources would be sufficient for our operations for at least the next twelve months.

The 621,000 shares of our common stock which we issued to Merial in conjunction with the 1997 acquisition of Synbiotics Europe SAS (SBIO-E) were subject to a put provision which gave Merial the right, beginning on July 9, 2001, to sell all or any portion of its shares to us at a price of $5 per share, for a total of $3,107,000. In June 2001, in conjunction with the assignment to Merial of our FeLV vaccine distribution rights, Merial waived its rights under the put provision. However, if we failed to make certain royalty payments to Merial through April 2002, the rights under the put provision would have reverted to Merial. We made the final scheduled payment in April 2002, and reclassified the carrying amount of the stock from mandatorily redeemable stock to permanent shareholders equity as of March 31, 2002.

Our operations are seasonal due to the sales of our canine heartworm diagnostic products. Our sales and profits tend to be concentrated in the first half of the year, as our distributors prepare for the heartworm season by purchasing diagnostic products for resale to veterinarians. The

operations of SBIO-E have reduced our seasonality as sales of their large animal diagnostic products tend to occur evenly throughout the year. In

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addition, sales of our SCA 2000 instruments and supplies and our poultry diagnostic products reduce our seasonality.

Certain Risk Factors

Our future operating results are subject to a number of factors, including:

We will need additional capital in the future

We currently anticipate that our existing cash balances and cash flow expected to be generated from future operations will be insufficient to meet our liquidity needs for at least the next twelve months. This is because we will not be able to repay the amended Comerica note when it comes due in January 2004, and we will have to restructure the note with Comerica or refinance it with another lending source. However, we may also need to raise additional funds if our estimates of revenues, working capital and/or capital expenditure requirements change or prove inaccurate or in order for us to respond to unforeseen technological or marketing hurdles or to take advantage of unanticipated opportunities.

Further, our future capital requirements will depend on many factors beyond our control or ability to accurately estimate, including continued scientific progress in our product development programs, the cost of manufacturing scale-up, the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims, the cost involved in patent infringement litigation, competing technological and market developments, and the cost of establishing effective sales and marketing arrangements. Such funds may not be available at the time or times needed, or available on terms acceptable to us. If adequate funds are not available, or are not available on acceptable terms, we may not be able to take advantage of market opportunities, to develop new products, or to otherwise respond to competitive pressures. This inability could materially harm our business.

The market in which we operate is intensely competitive, even with regard to our key canine heartworm diagnostic products, and many of our competitors are larger and more established

The market for animal health care products is extremely competitive. Companies in the animal health care market compete to develop new products, to market and manufacture products efficiently, to implement effective research strategies, and to obtain regulatory approval. Our current competitors include IDEXX Laboratories, a significantly larger company, and Heska Corporation. These companies have greater financial, manufacturing, marketing, and research resources than we do. IDEXX Laboratories combination in-clinic diagnostic test has gained some market share from our in-clinic canine heartworm diagnostic tests. In addition, IDEXX Laboratories prohibits its distributors from selling competitors products, including ours. Further, additional competition could come from new entrants to the animal health care market. We cannot assure you that we will be able to compete successfully in the future or that competition will not harm our business.

Our canine heartworm diagnostic products constituted 36% of our sales for the year ended December 31, 2002. In addition to our historic competition with IDEXX Laboratories, the sales leader in this product category, our sales have been substantially affected since 1999 by a heartworm product from Heska.

We have a history of losses and an accumulated deficit

We did not achieve profitability for the years ended December 31, 2002 and 2000, and we have had a history of annual losses. We have incurred a consolidated accumulated deficit of $46,167,000 at December 31, 2002. We may not achieve annual profitability again and if we are profitable in the future there can be no assurance that profitability can be sustained.

We rely on third party distributors for a substantial portion of our sales

We have historically depended upon distributors for a large portion of our sales, and we may not have the ability to establish and maintain an adequate independent sales and marketing capability in any or all of our

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targeted markets. Distributor agreements render our sales exposed to the efforts of third parties who are not employees of Synbiotics and over whom we have no control. Their failure to generate significant sales of our products could materially harm our business. Reduction by these distributors of the quantity of our products which they distribute would materially harm our business. Also, the distributors are not bound to us by long-term agreements, and a decision by any major distributor to stop doing business with us could materially hurt our revenues. IDEXX Laboratories prohibition against its distributors carrying competitors products, including ours, has made, and could continue to make, some distributors unavailable to us. We lost a major distributor to IDEXX Laboratories in 2002.

The effects of our liquidity issue may linger

Cash was extremely tight for us throughout 2001 and into 2002, and at times we were on credit hold with several of our key suppliers. Our lack of liquidity may have had a detrimental impact on our business in 2001 and into 2002. Moreover, due to the scheduled December 2002 payout of $406,000 of cash retention bonuses and due to the decrease in our sales during the year ended December 31, 2002, our cash is again extremely tight for us. As a result, at the end of the third quarter of 2002, we began implementing a cost reduction program, which included a substantial reduction in our headcount.

We depend on key executives and personnel, but we have experienced executive turnover

Our future success will depend, to a significant extent, on the ability of our management to operate effectively, both individually and as a group. Competition for qualified personnel in the animal health care products industry is intense, and we may not be successful in attracting and retaining such personnel. There are only a limited number of persons with the requisite skills to serve in those positions and it may become increasingly difficult to hire such persons. The loss of the services of any of our key personnel or the inability to attract or retain qualified personnel could harm our business. At the end of the third quarter of 2002, our chief executive officer and our chief financial officer both resigned. We replaced our chief financial officer by promoting our corporate controller, and we hired a new president at the end of December 2002.

We depend on third party manufacturers, and may experience problems in obtaining supplies of our key products

We contract for the manufacture of some of our products, including our Witness® canine heartworm and feline leukemia diagnostic products and our SCA 2000 products. We also expect that some of our anticipated new products will be manufactured by third parties. In addition, some of the products manufactured for us by third parties, including Witness® canine heartworm and feline leukemia diagnostic products, are licensed to us by their manufacturers. There are a number of risks associated with our dependence on third-party manufacturers including:

- the potential fro a decision by the manufacturer to make and market competing products;
- reduced control over delivery schedules;
- quality assurance;

manufacturing yields and costs;

the potential lack of adequate capacity during periods of excess demand;

limited warranties on products supplied to us;

increases in prices and the potential misappropriation of our intellectual property; and

limited negotiating leverage in the event of disputes with the third-party manufacturers.

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If our third party manufacturers fail to supply us with an adequate number of finished products, our business would be significantly harmed. We have no long-term contracts or arrangements with any of our vendors that guarantee product availability, the continuation of particular payment terms or the extension of credit limits.

If we encounter delays or difficulties in our relationships with our manufacturers, the resulting problems could have a material adverse effect on us.

In June 2001, Kirkegaard and Perry Laboratories, Inc. (KPL) instituted a recall of substantially all of our poultry diagnostic products that were manufactured by KPL due to a defective conjugate contained in the products. We replaced the affected products that were held by our customers. The cost of this recall and the related replacement products was borne by KPL. However, our sales of poultry diagnostic products since then have been materially adversely affected. In the first quarter of 2002, KPL instituted another recall of certain of our poultry diagnostic products that were manufactured by KPL due to a contaminated positive control contained in the products. We completed the transfer of the manufacturing of these products to our San Diego manufacturing facility during the first quarter of 2002.

We rely on new and recent products

We rely to a significant extent on new and recently developed products, and expect that we will need to continue to introduce new products to be successful in the future. There can be no assurance that we will obtain and maintain market acceptance of our products. There can be no assurance that future products will meet applicable regulatory standards, be capable of being produced in commercial quantities at acceptable cost or be successfully commercialized.

There can be no assurance that new products can be manufactured at a cost or in quantities necessary to make them commercially viable. If we are unable to produce internally, or to contract for, a sufficient supply of our new products on acceptable terms, or if we should encounter delays or difficulties in our relationships with manufacturers, the introduction of new products would be delayed, which could have a material adverse effect on our business.

Our canine heartworm business is seasonal

Our operations are seasonal due to the timing of sales of our canine heartworm diagnostic products. Our sales and profits tend to be concentrated in the first half of the year as our distributors prepare for the heartworm season by purchasing diagnostic products for resale to veterinarians. One effect of this is a need to devote large amounts of cash to building canine heartworm diagnostic products inventory in preparation for the canine heartworm selling season at a time when our working capital is relatively low.

Any failure to adequately establish or protect our proprietary rights may adversely affect us

We rely on a combination of patent, copyright, and trademark laws, trade secrets, and confidentiality and other contractual provisions to protect our proprietary rights. These measures afford only limited protection. We currently have 13 issued U.S. patents and one pending patent application. Our means of protecting our proprietary rights in the U.S. or abroad may not be adequate and competitors may independently develop similar technologies. Our future success will depend in part on our ability to protect our proprietary rights and the technologies used in our principal products. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use trade secrets or other information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. Issued patents may not preserve our proprietary position. Even if they do, competitors or others may develop technologies similar to or superior to our own. If we do not enforce and protect our intellectual property, our business will be harmed. From time to time, third parties, including our competitors, have asserted patent, copyright, and other intellectual property rights to technologies that are

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important to us. We expect that we will increasingly be subject to infringement claims as the number of products and competitors in the animal health care market increases.

The results of any litigated matter are inherently uncertain. In the event of an adverse result in any litigation with third parties that could arise in the future, we could be required to:

- pay substantial damages, including treble damages if we are held to have willfully infringed;
- cease the manufacture, use and sale of infringing products;
- expend significant resources to develop non-infringing technology; or
- obtain licenses to the infringing technology.

Licenses may not be available from any third party that asserts intellectual property claims against us on commercially reasonable terms, or at all.

Also, litigation is costly regardless of its outcome and can require significant management attention.

Also, because our patents and patent applications cover novel diagnostic approaches:

- the patent coverage which we receive could be significantly narrower than the patent coverage we seek in our patent applications; and
- our patent positions involve complex legal and factual issues which can be hard for patent examiners or lawyers asserting patent coverage to successfully resolve.

Because of this, our patent position could be vulnerable and our business could be materially harmed.

The U.S. patent application system also exposes us to risks. In the United States, the first party to make a discovery is granted the right to patent it and patent applications are generally maintained in secrecy for 18 months. For these reasons, we can never know if we are the first to discover particular technologies. Therefore, we can never be certain that our technologies will be patented and we could become involved in lengthy, expensive, and distracting disputes concerning whether we were the first to make the disputed discovery. Any of these events would materially harm our business.

Our business is regulated by the United States and various foreign governments

Our business is subject to substantial regulation by the United States government, most notably the United States Department of Agriculture, and the French government. In addition, our operations may be subject to future legislation and/or rules issued by domestic or foreign governmental agencies with regulatory authority relating to our business. There can be no assurance that we will continue to be in compliance with any of these regulations.

For marketing outside the United States, we and our suppliers are subject to foreign regulatory requirements, which vary widely from country to country. There can be no assurance that we and our suppliers will meet and sustain compliance with any such requirements.

We use hazardous materials

Our business requires that we store and use hazardous materials and chemicals. Although we believe that our procedures for storing, handling, and disposing of these materials comply with the standards prescribed by local, state, and federal regulations, the risk of accidental contamination or injury from these materials cannot be completely eliminated. If any of these materials were mishandled, or if an accident with them occurred, the

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consequences could be extremely damaging and we could be held liable for them. Our liability for such an event would materially harm our business and could exceed all of our available resources for satisfying it.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Our market risk consists primarily of the potential for changes in interest rates and foreign currency exchange rates.

Interest Rate Risk

The fair value of our interest bearing debt at December 31, 2002 was $5,991,000, which has a variable interest rate based on the prime rate.

A change in interest rates of five percentage points would have a material impact on our financial condition, results of operations and cash flows as it relates to our variable rate debt. In addition, if interest rates increased by five percentage points our ability to refinance our bank debt would be seriously compromised.

Foreign Currency Exchange Rate Risk

Our foreign currency exchange rate risk relates to the operations of SBIO-E as it transacts business in Euros, its local currency. However, this risk is limited to our intercompany receivable from SBIO-E and the conversion of its financial statements into the U.S. dollar for consolidation. There is no foreign currency exchange rate risk related to SBIO-E s transactions outside of the European Union as those transactions are denominated in Euros and, to a lesser extent, U.S. dollars. Similarly, all of the foreign transactions of our U.S. operations are denominated in U.S. dollars. We do not hedge our cash flows on intercompany transactions, nor do we hold any other derivative securities or hedging instruments based on currency exchange rates. As a result, the effects of a 5% change in exchange rates would have a material impact on our financial condition, results of operations and cash flows, but only to the extent that it relates to the conversion of SBIO-E s financial statements, including its intercompany payable, into the U.S. dollar for consolidation.

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Item 8. Financial Statements and Supplementary Data

Index to Financial Statements

All other schedules are omitted because they are not applicable or the required information is included in the consolidated financial statements and notes thereto.

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INDEPENDENT AUDITOR S REPORT

To the Board of Directors

and Shareholders of

Synbiotics Corporation

We have audited the consolidated financial statements listed in the accompanying index of Synbiotics Corporation and its subsidiary as of December 31, 2002, and for the year then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audit. The consolidated financial statements of Synbiotics Corporation and its subsidiary as of December 2001 and 2000, were audited by other auditors whose report dated March 27, 2002 expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Synbiotics Corporation and its subsidiary as of December 31, 2002, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company incurred a net loss of $14,401,000 in 2002, has an accumulated deficit of $46,167,000, and has a note payable of $5,991,000 which is payable in full on January 25, 2004. These factors, among others, raise substantial doubt about its ability to continue as a going concern. Management s plans in regards to these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

LEVITZ, ZACKS & CICERIC

Certified Public Accountants

San Diego California

February 28, 2003, except for

Note 15 relating to the March 2003

settlement, for which the date is

March 28, 2003

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SYNBIOTICS CORPORATION

CONSOLIDATED BALANCE SHEET

	December 31,	
	2002	**2001**
ASSETS		
Current assets:		
Cash and equivalents	$ 869,000	$ 1,039,000
Accounts receivable (net of allowance for doubtful accounts of $164,000 and $166,000 in 2002 and 2001)	2,455,000	2,983,000
Inventories	5,438,000	5,059,000
Other current assets	673,000	796,000
	9,435,000	9,877,000
Property and equipment, net	1,409,000	1,648,000
Goodwill, net	1,397,000	12,074,000
Intangibles, net	2,737,000	2,744,000
Deferred debt issuance costs		7,000
Other assets	458,000	152,000
	$ 15,436,000	$ 26,502,000
LIABILITIES AND SHAREHOLDERS EQUITY:		
Current Liabilities:		
Accounts payable and accrued expenses	$ 4,919,000	$ 5,915,000
Current portion of long-term debt	1,475,000	1,200,000
Deferred revenue		300,000
	6,394,000	7,415,000
Long-term debt	4,516,000	6,032,000
Other liabilities	1,962,000	1,804,000
	6,478,000	7,836,000
Mandatorily redeemable common stock		3,107,000
Commitments and contingencies (Note 15)		
Non-mandatorily redeemable common stock and other shareholders equity:		
Common stock, no par value, 70,000,000 shares authorized, 17,954,000 and 8,990,000 shares issued and outstanding at December 31, 2002 and 2001	46,050,000	40,286,000
Series C preferred stock, $1,000 liquidation preference per share (aggregating $2,800,000 at December 31, 2002), 4,000 shares authorized, 2,800 shares issued and outstanding at December 31, 2002	2,604,000	
Common stock warrants	1,035,000	1,035,000
Accumulated other comprehensive loss	(958,000)	(1,411,000)
Accumulated deficit	(46,167,000)	(31,766,000

Total non-mandatorily redeemable common stock and other shareholders equity	2,564,000	8,144,000
	$ 15,436,000	$ 26,502,000

See accompanying notes to consolidated financial statements.

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SYNBIOTICS CORPORATION

CONSOLIDATED STATEMENT OF OPERATIONS AND COMPREHENSIVE (LOSS) INCOME

	Year Ended December 31,		
	2002	2001	2000
Revenues:			
Net sales	$ 21,362,000	$ 25,505,000	$ 29,482,000
License fees	300,000	1,019,000	242,000
Royalties	9,000	8,000	14,000
	21,671,000	26,532,000	29,738,000
Operating expenses:			
Cost of sales	10,450,000	11,425,000	15,240,000
Research and development	1,380,000	1,604,000	1,741,000
Selling and marketing	4,378,000	5,684,000	8,858,000
General and administrative	8,772,000	6,246,000	6,048,000
Impairment losses	2,877,000		985,000
	27,857,000	24,959,000	32,872,000
(Loss) income from operations	(6,186,000)	1,573,000	(3,134,000)
Other expense:			
Interest, net	(669,000)	(937,000)	(1,344,000)
(Loss) income before income taxes	(6,855,000)	636,000	(4,478,000)
Provision for income taxes	7,000	10,000	8,715,000
(Loss) income from continuing operations	(6,862,000)	626,000	(13,193,000)
Discontinued operations, net of tax	217,000	(195,000)	(4,727,000)
(Loss) income before extraordinary item	(6,645,000)	431,000	(17,920,000)
Early extinguishment of debt, net of tax			(598,000)
(Loss) income before cumulative effect of a change in accounting principle	(6,645,000)	431,000	(18,518,000)
Cumulative effect of a change in accounting principle, net of tax	(7,756,000)		
Net (loss) income	(14,401,000)	431,000	(18,518,000)
Translation adjustment	453,000	(326,000)	(169,000)
Comprehensive (loss) income	$ (13,948,000)	$ 105,000	$ (18,687,000)
Basic and diluted (loss) income per share:			
(Loss) income from continuing operations	$ (0.48)	$ 0.06	$ (1.43)
Discontinued operations, net of tax	.01	(0.02)	(0.50)

Early extinguishment of debt, net of tax			(0.07)
Cumulative effect of a change in accounting principle, net of tax	$ (0.53)		
Net (loss) income	$ (1.00)	$ 0.04	$ (2.00)

See accompanying notes to consolidated financial statements.

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SYNBIOTICS CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS

	Year Ended December 31,		
	2002	2001	2000
Cash flows from operating activities:			
Net (loss) income	$ (14,401,000)	$ 431,000	$ (18,518,000)
Adjustments to reconcile net (loss) income to net cash (used for) provided by operating activities:			
Depreciation and amortization	899,000	2,324,000	2,206,000
Retention bonus payable in common stock	2,641,000		
Legal settlement payable in common stock	15,000		
Stock compensation			132,000
Impairment losses	2,877,000		3,985,000
Note receivable for discontinued operations	(500,000)		
Loss on early extinguishment of debt			937,000
Cumulative effect of a change in accounting principle	7,756,000		
Changes in assets and liabilities, net of effect of acquisitions:			
Accounts receivable	802,000	394,000	1,027,000
Inventories	(125,000)	144,000	72,000
Deferred taxes		108,000	8,438,000
Other assets	267,000	124,000	159,000
Accounts payable and accrued expenses	(1,475,000)	63,000	249,000
Deferred revenue	(300,000)	(669,000)	(242,000)
Other liabilities	150,000	138,000	122,000
Net cash (used for) provided by operating activities	(1,394,000)	3,057,000	(1,433,000)
Cash flows from investing activities:			
Acquisition of property and equipment	(193,000)	(232,000)	(640,000)
Proceeds from sale of investment in W3 held for sale		9,000	
Proceeds from sale of securities available for sale			3,443,000
Acquisition of KPL poultry product line		(1,159,000)	(3,554,000)
Additional purchase price for prior acquisition		(368,000)	
Net cash (used for) investing activities	(193,000)	(1,750,000)	(751,000)
Cash flows from financing activities:			
Proceeds from issuance of long-term debt			10,000,000
Payments of long-term debt	(1,241,000)	(1,200,000)	(9,068,000)
Debt issuance costs			(40,000)
Proceeds from exercise of common stock options and warrants			152,000
Proceeds from issuance of preferred stock, net	2,604,000		
Net cash provided by (used for) financing activities	1,363,000	(1,200,000)	1,044,000

Net increase (decrease) in cash and equivalents	(224,000)	107,000	(1,140,000)
Effect of exchange rates on cash	54,000	(19,000)	(169,000)
Cash and equivalents beginning of period	1,039,000	951,000	2,260,000
Cash and equivalents end of period	$ 869,000	$ 1,039,000	$ 951,000

See accompanying notes to consolidated financial statements.

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SYNBIOTICS CORPORATION

CONSOLIDATED STATEMENT OF NON-MANDATORILY REDEEMABLE

COMMON STOCK AND OTHER SHAREHOLDERS EQUITY

	Common Stock		Preferred Stock					Accumulated Other Comprehensive		
			Series B		Series C		Common Stock Warrants	Income (Loss)	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount	Shares	Amount				
Balance, December 31, 1999	8,576,000	$ 39,424,000					$ 1,003,000	$ (916,000)	$ (13,468,000)	$ 26,043,000
Issuance of common stock pursuant to exercise of stock options	24,000	75,000								75,000
Issuance of common stock pursuant to employee bonus plan, net of forfeitures	(2,000)	100,000								