INVERNESS MEDICAL INNOVATIONS INC
Form 10-Q/A
February 14, 2005

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# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q/A

**(Amendment No. 1)**

**(Mark One)**

ý **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**

o **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 001-16789**

# INVERNESS MEDICAL INNOVATIONS, INC.

(Exact Name of Registrant as Specified in its Charter)

| **DELAWARE** | **04-3565120** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**51 SAWYER ROAD, SUITE 200**
**WALTHAM, MASSACHUSETTS 02453**
(Address of principal executive offices)

**(781) 647-3900**
(Registrant's Telephone Number, Including Area Code)

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 filing requirements for the past 90 days. Yes ý No o

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

The number of shares outstanding of the registrant's common stock as of August 6, 2004 was 20,289,642.

**INVERNESS MEDICAL INNOVATIONS, INC.**

**FORM 10-Q**

For the Quarterly Period Ended June 30, 2004

*This quarterly report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Readers can identify these statements by forward-looking words such as "may," "could," "should," "would," "intend," "will," "expect," "anticipate," "believe," "estimate," "continue" or similar words. There are a number of important factors that could cause actual results of Inverness Medical Innovations, Inc. and its subsidiaries to differ materially from those indicated by such forward-looking statements. These factors include, but are not limited to, the risk factors detailed in this quarterly report on Form 10-Q and other risk factors identified from time to time in our periodic filings with the Securities and Exchange Commission. Readers should carefully review the factors discussed in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations Certain Factors Affecting Future Results" and "Special Statement Regarding Forward-Looking Statements" beginning on pages 45 and 61, respectively, in this quarterly report on Form 10-Q and should not place undue reliance on our forward-looking statements. These forward-looking statements are based on information, plans and estimates at the date of this report. We undertake no obligation to update any forward-looking statements to reflect changes in underlying assumptions or factors, new information, future events or other changes.*

*Unless the context requires otherwise, references in this quarterly report on Form 10-Q to "we," "us," and "our" refer to Inverness Medical Innovations, Inc. and its subsidiaries.*

*We have registered or are using the following trademarks which appear in this quarterly report on Form 10-Q: Clearblue , Clearblue Easy®, Fact plus®, Persona®, Clearview®, Wampole®, Testpack , Signify®, Ferro-Sequels , Stresstabs®, Protegra®, Posture®, SoyCare , ALLBEE®, and Z-BEC®.*

*The following are registered trademarks of parties other than us: Abbott®, Abbott TestPack®, Abbott TestPack plus® and e.p.t®.*

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**EXPLANATORY NOTE**

On December 2, 2004, we announced that our previously issued consolidated financial statements as of and for the years ended December 31, 2002 and 2003, and for the interim periods during 2004, contained an error in the application of accounting principles generally accepted in the United States of America relating to the calculation of our provision for income taxes and the related deferred taxes. In connection with a routine review of our Annual Report on Form 10-K for the fiscal year ended December 31, 2003, as amended ("Form 10-K"), by the Securities and Exchange Commission's Division of Corporation Finance, we also revised our purchase price allocation in connection with our acquisition of the rapid diagnostics business that we acquired from Abbott Laboratories on September 30, 2003 in order to attribute approximately $5.7 million to customer related intangible assets acquired in the acquisition and to reduce goodwill by the same amount. We have also recorded as of the date of the acquisition approximately $11.3 million in other assets acquired from Abbott Laboratories, the amortization of which amounted to approximately $50,000 per quarter, that we had originally recognized in our Quarterly Report on Form 10-Q for the period ended September 30, 2004, and commenced amortization in connection with all amortizable acquired assets as of the same date. The impact of all additional non-cash amortization on our operating results, net of tax effect, was to reduce previously reported net income by approximately $800,000, or $0.04 per share, for the second quarter of 2004. This Amendment No. 1 (the "Amended Report") to our Quarterly Report on Form 10-Q for the period ended June 30, 2004 (the"Original Report") has been filed to address these issues in the Original Report and in the consolidated financial statements as of June 30, 2004 and for the three and six months ended June 30, 2004 and 2003, respectively, contained therein. We have also amended our Form 10-K and our Quarterly Reports on Form 10-Q for the periods ended March 31, 2004 and September 30, 2004.

The correction of the error relating to our tax provision results in an incremental non-cash provision of income taxes. The changes to our purchase price allocation for the acquisition of the rapid diagnostics business from Abbott Laboratories result in additional non-cash amortization over the lives of the assets identified.

For the reasons discussed above, we are filing this Amended Report in order to amend Part I. Item 1 "Consolidated Financial Statements (unaudited)," Part I. Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Part II. Item 6 "Exhibits and Reports on Form 8-K" of the Original Report to the extent necessary to reflect the adjustments discussed above. We also amended such sections to delete discussions and analysis regarding earnings before interest, taxes and depreciation and amortization and to revise certain other disclosures. The remaining Items of our Original Report are not amended hereby and are repeated herein only for the reader's convenience.

In order to preserve the nature and character of the disclosures set forth in the Original Report, except as expressly noted above, this report speaks as of the date of the filing of the Original Report, August 9, 2004, and we have not updated the disclosures in this report to speak as of a later date. All information contained in this Amended Report is subject to updating and supplementing as provided in our reports filed with the SEC subsequent to the date of the Original Report.

**PART I FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**(UNAUDITED)**

(in thousands, except per share amounts)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| | (restated) | (restated) | (restated) | (restated) |
| Net product sales | $ 86,730 | $ 63,925 | $ 174,931 | $ 126,904 |
| License revenue | 1,997 | 1,792 | 4,497 | 3,915 |
| **Net revenue** | 88,727 | 65,717 | 179,428 | 130,819 |
| Cost of sales | 53,723 | 37,043 | 107,515 | 72,315 |
| **Gross profit** | 35,004 | 28,674 | 71,913 | 58,504 |
| Operating expenses: | | | | |
| Research and development | 7,992 | 5,957 | 15,415 | 10,642 |
| Sales and marketing | 13,661 | 12,157 | 28,012 | 23,698 |
| General and administrative | 14,137 | 8,010 | 25,457 | 16,376 |
| Stock-based compensation(1) | | | | 6 |
| Total operating expenses | 35,790 | 26,124 | 68,884 | 50,722 |
| **Operating (loss) income** | (786) | 2,550 | 3,029 | 7,782 |
| Interest expense, including amortization of discounts and write-off of deferred financing costs (Note 8) | (4,541) | (1,909) | (12,311) | (4,280) |
| Other income, net | 29 | 5,732 | 476 | 6,020 |
| **(Loss) income before income taxes** | (5,298) | 6,373 | (8,806) | 9,522 |
| Income tax provision | 1,759 | 1,152 | 1,922 | 2,389 |
| **Net (loss) income** | $ (7,057) | $ 5,221 | $ (10,728) | $ 7,133 |
| **Net (loss) income available to common stockholders basic (Note 5)** | $ (7,057) | $ 5,080 | $ (11,477) | $ 6,818 |
| **Net (loss) income available to common stockholders diluted (Note 5)** | $ (7,057) | $ 5,229 | $ (11,477) | $ 7,149 |

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| **Net (loss) income per common share basic (Note 5)** | $ (0.36) | $ 0.36 | $ (0.59) | $ 0.49 |
| **Net (loss) income per common share diluted (Note 5)** | $ (0.36) | $ 0.31 | $ (0.59) | $ 0.43 |
| **Weighted average shares basic (Note 5)** | 19,701 | 14,021 | 19,568 | 13,911 |
| **Weighted average shares diluted (Note 5)** | 19,701 | 16,660 | 19,568 | 16,551 |

(1) The charge for stock-based compensation for the six months ended June 30, 2003 was classified as general and administrative expenses.

The accompanying notes are an integral part of these consolidated financial statements.

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**(UNAUDITED)**

(in thousands, except per share amounts)

| | June 30, 2004 | December 31, 2003 |
|---|---|---|
| | (restated) | (restated) |
| **ASSETS** | | |
| **Current assets:** | | |
| Cash and cash equivalents | $ 21,995 | $ 24,622 |
| Accounts receivable, net of allowances of $7,650 at June 30, 2004 and $7,492 at December 31, 2003 | 53,385 | 55,418 |
| Inventories | 55,069 | 47,423 |
| Deferred tax assets | 1,178 | 1,178 |
| Prepaid expenses and other current assets | 9,147 | 10,599 |
| **Total current assets** | 140,774 | 139,240 |
| Property, plant and equipment, net | 61,003 | 57,773 |
| Goodwill | 222,527 | 216,733 |
| Other intangible assets with indefinite lives | 50,054 | 46,719 |
| Core technology and patents, net | 36,845 | 37,942 |
| Other intangible assets, net | 29,837 | 32,679 |
| Deferred financing costs, net, and other non-current assets | 8,912 | 7,457 |
| Deferred tax assets | 1,130 | 1,456 |
| **Total assets** | $ 551,082 | $ 539,999 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| **Current liabilities:** | | |
| Current portion of long-term debt | $ 1,519 | $ 14,055 |
| Current portion of capital lease obligations | 460 | 457 |
| Accounts payable | 32,119 | 38,006 |
| Accrued expenses and other current liabilities | 47,347 | 41,122 |
| **Total current liabilities** | 81,445 | 93,640 |
| **Long-term liabilities:** | | |
| Long-term debt, net of current portion | 188,011 | 159,838 |
| Capital lease obligations, net of current portion | 1,593 | 1,831 |
| Deferred tax liabilities | 11,496 | 9,118 |
| Other long-term liabilities | 3,585 | 3,307 |
| **Total long-term liabilities** | 204,685 | 174,094 |
| **Commitments and contingencies** | | |
| **Series A redeemable convertible preferred stock, $0.001 par value:** | | |
| Authorized 2,667 shares | | |
| Issued 2,527 shares at June 30, 2004 and December 31, 2003 | | |
| Outstanding none at June 30, 2004 and 208 shares at December 31, 2003 | | 6,185 |
| **Stockholders' equity:** | | |

| | June 30, 2004 | December 31, 2003 |
|---|---|---|
| Preferred stock, $0.001 par value: | | |
| Authorized 2,333 shares, none issued | | |
| Common stock, $0.001 par value: | | |
| Authorized 50,000 shares | | |
| Issued and outstanding 20,259 shares at June 30, 2004 and 19,640 shares at December 31, 2003 | 20 | 20 |
| Additional paid-in capital | 352,185 | 341,703 |
| Notes receivable from stockholders | (14,691) | (14,691) |
| Accumulated deficit | (84,242) | (72,765) |
| Accumulated other comprehensive income | 11,680 | 11,813 |
| **Total stockholders' equity** | 264,952 | 266,080 |
| **Total liabilities and stockholders' equity** | $ 551,082 | $ 539,999 |

The accompanying notes are an integral part of these consolidated financial statements.

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(UNAUDITED)**

**(in thousands)**

| | Six Months Ended June 30, | |
|---|---|---|
| | **2004** | **2003** |
| | **(restated)** | **(restated)** |
| **Cash Flows from Operating Activities:** | | |
| Net (loss) income | $ (10,728) | $ 7,133 |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: | | |
| Interest expense related to amortization and/or write-off of noncash original issue discount and deferred financing costs | 3,960 | 648 |
| Noncash gain related to interest rate swap agreement | (434) | (87) |
| Noncash stock-based compensation expense | | 6 |
| Depreciation and amortization | 11,379 | 7,051 |
| Deferred income taxes | 1,282 | 1,313 |
| Other noncash items | (79) | (2) |
| Changes in assets and liabilities, net of acquisitions: | | |
| Accounts receivable, net | 2,569 | (832) |
| Inventories | (6,659) | (3,368) |
| Prepaid expenses and other current assets | 1,430 | (2,142) |
| Accounts payable | (6,508) | (1,737) |
| Accrued expenses and other current liabilities | 9,534 | (6,297) |
| Increase in other long-term liabilities | 302 | |
| **Net cash provided by operating activities** | 6,048 | 1,686 |
| **Cash Flows from Investing Activities:** | | |
| Purchases of property, plant and equipment | (9,925) | (5,555) |
| Proceeds from sale of property, plant and equipment | 182 | 143 |
| Payments for acquisitions and intellectual property | (8,486) | (4,221) |
| Increase in other assets | (794) | (593) |
| **Net cash used in investing activities** | (19,023) | (10,226) |
| **Cash Flows from Financing Activities:** | | |
| Cash paid for financing costs | (5,117) | (112) |
| Proceeds from issuance of common stock, net of issuance costs | 546 | 809 |
| Proceeds from issuance of senior subordinated notes | 150,000 | |
| Net (repayment) proceeds from revolving lines of credit | (39,958) | 2,313 |
| Repayments of notes payable | (94,505) | (2,651) |
| Principal payments of capital lease obligations | (242) | (340) |
| **Net cash provided by financing activities** | 10,724 | 19 |
| Foreign exchange effect on cash and cash equivalents | (376) | 2,873 |

| | Six Months Ended June 30, | |
|---|---|---|
| **Net decrease in cash and cash equivalents** | (2,627) | (5,648) |
| **Cash and cash equivalents, beginning of period** | 24,622 | 30,668 |
| **Cash and cash equivalents, end of period** | $ 21,995 | $ 25,020 |
| **Supplemental Disclosure of Noncash Activities:** | | |
| Dividends, redemption interest and amortization of beneficial conversion feature related to preferred stock | $ 749 | $ 315 |
| Fair value of stock issued for acquisitions and intellectual property | $ 3,002 | $ 26,037 |
| Fair value of assumed and fully-vested stock options and warrants for acquisitions | $ | $ 1,752 |
| Conversion of preferred stock into common stock | $ 6,934 | $ |

The accompanying notes are an integral part of these consolidated financial statements.

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**(1) Basis of Presentation of Financial Information**

The accompanying consolidated financial statements of Inverness Medical Innovations, Inc. and its subsidiaries are unaudited. In the opinion of management, the unaudited consolidated financial statements contain all adjustments considered normal and recurring and necessary for their fair presentation. Interim results are not necessarily indicative of results to be expected for the year. These interim financial statements have been prepared in accordance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a complete presentation of operations, financial position, and cash flows in conformity with accounting principles generally accepted in the United States of America ("GAAP"). Our audited consolidated financial statements for the year ended December 31, 2003 included information and footnotes necessary for such presentation and were included in our annual report on Form 10-K/A, Amendment No. 3, filed with the Securities and Exchange Commission ("SEC") on February 11, 2005. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements and notes thereto for the year ended December 31, 2003.

In connection with our restatements for the years ended December 31, 2003 and 2002, as discussed in our 2003 annual report on Form 10-K/A, Amendment No. 3, we also restated our consolidated financial statements for the three and six months ended June 30, 2004 and 2003, respectively, to reflect corrections to our income tax provisions and revisions to the purchase price allocation for the acquisition of the rapid diagnostics business from Abbott Laboratories on September 30, 2003 (and the resulting additional non-cash amortization charges). Such adjustments are reflected in the accompanying consolidated financial statements for the three and six months ended June 30, 2004 and 2003, respectively, and discussed in Note 13 herein.

**(2) Cash and Cash Equivalents**

We consider all highly liquid cash investments with original maturities of three months or less at the date of acquisition to be cash equivalents. At June 30, 2004, our cash equivalents consisted of money market funds.

**(3) Inventories**

Inventories are stated at the lower of cost (first in, first out) or market and are comprised of the following:

| | June 30, 2004 | December 31, 2003 |
|---|---|---|
| | (in thousands) | |
| Raw materials | $ 22,761 | $ 19,986 |
| Work-in-process | 15,633 | 12,631 |
| Finished goods | 16,675 | 14,806 |
| | $ 55,069 | $ 47,423 |

**(4) Employee Stock-Based Compensation Arrangements**

For all periods presented in the accompanying unaudited consolidated financial statements, we accounted for our employee stock-based compensation arrangements using the intrinsic value method

under the provisions of Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and in accordance with Financial Accounting Standards Board ("FASB") Interpretation ("FIN") No. 44, *Accounting for Certain Transactions Involving Stock Compensation*. We have elected to use the disclosure-only provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation*, and SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure.*

Had compensation expense for stock option grants to employees been determined based on the fair value method at the grant dates for awards under the stock option plans consistent with the method prescribed by SFAS No. 123, our net (loss) income would have been (increased) decreased to the pro forma amounts indicated as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2004 | 2003(b) | 2004 | 2003(b) |
| | (restated) | (restated) | (restated) | (restated) |
| | (in thousands, except per share amounts) | | | |
| Net (loss) income as reported | $ (7,057) | $ 5,221 | $ (10,728) | $ 7,133 |
| Stock-based employee compensation as reported(a) | | | | 1 |
| Pro forma stock-based employee compensation | (1,203) | (1,022) | (2,805) | (2,222) |
| Net (loss) income pro forma | $ (8,260) | $ 4,199 | $ (13,533) | $ 4,912 |
| (Loss) income per share basic: | | | | |
| Net (loss) income per share as reported | $ (0.36) | $ 0.36 | $ (0.59) | $ 0.49 |
| Stock-based employee compensation as reported | | | | |
| Pro forma stock-based employee compensation | (0.06) | (0.07) | (0.15) | (0.16) |
| Net (loss) income per share pro forma | $ (0.42) | $ 0.29 | $ (0.74) | $ 0.33 |
| (Loss) income per share diluted: | | | | |
| Net (loss) income per share as reported | $ (0.36) | $ 0.31 | $ (0.59) | $ 0.43 |
| Stock-based employee compensation as reported | | | | |
| Pro forma stock-based employee compensation | (0.06) | (0.06) | (0.15) | (0.14) |
| Net (loss) income per share pro forma | $ (0.42) | $ 0.25 | $ (0.74) | $ 0.29 |

(a) Stock-based employee compensation expense, as reported, primarily represents the amortization of deferred compensation of certain stock options that were granted to employees below fair market value. This amount excludes stock-based compensation expense recognized in connection with stock options that were granted to non-employees.

(b) Pro forma stock-based employee compensation charge and related per share charge for the three and six months ended June 30, 2003 have been adjusted to reflect estimated tax benefits associated with such charge.

We have computed the pro forma disclosures for stock options granted to employees after January 1, 1995 using the Black-Scholes option pricing model prescribed by SFAS No. 123. The assumptions used were as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| Risk-free interest rate | 2.87-3.95% | 2.3-2.4% | 2.8-3.95% | 2.3-3.1% |
| Expected dividend yield | | | | |
| Expected lives | 5 years | 5 years | 5 years | 5 years |
| Expected volatility | 48% | 56% | 48% | 57% |

The weighted average fair value under the Black-Scholes option pricing model of options granted to employees during the three months ended June 30, 2004 and 2003 were $9.01 and $8.46, respectively. The weighted average fair value under the Black-Scholes option pricing model of options granted to employees during the six months ended June 30, 2004 and 2003 were $9.19 and $8.30, respectively.

**(5) Earnings Per Share**

The following table sets forth the computation of basic and diluted earnings per share:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| | (restated) | (restated) | (restated) | (restated) |
| | (in thousands, except per share amounts) | | | |
| **Numerator:** | | | | |
| Net (loss) income | $ (7,057) | $ 5,221 | $ (10,728) | $ 7,133 |
| Dividends, redemption interest and amortization of beneficial conversion feature related to Series A Preferred Stock | | (141) | (749) | (315) |
| Net (loss) income available to common stockholders basic | (7,057) | 5,080 | (11,477) | 6,818 |
| Interest on convertible promissory notes and dividends and redemption interest related to Series A Preferred Stock | | 149 | | 331 |
| Net (loss) income available to common stockholders diluted | $ (7,057) | $ 5,229 | $ (11,477) | $ 7,149 |
| **Denominator:** | | | | |
| Denominator for basic (loss) income per share weighted average shares | 19,701 | 14,021 | 19,568 | 13,911 |
| Effect of dilutive securities: | | | | |
| Employee stock options | | 479 | | 416 |
| Warrants | | 171 | | 156 |
| Restricted stock and escrow shares | | 999 | | 1,078 |
| Convertible promissory notes | | 344 | | 344 |
| Series A Preferred Stock | | 646 | | 646 |
| Dilutive potential common shares | | 2,639 | | 2,640 |
| Denominator for dilutive (loss) income per share adjusted weighted average shares and assumed conversions | 19,701 | 16,660 | 19,568 | 16,551 |
| Net (loss) income per share basic | $ (0.36) | $ 0.36 | $ (0.59) | $ 0.49 |
| Net (loss) income per share diluted | $ (0.36) | $ 0.31 | $ (0.59) | $ 0.43 |

We had the following potential dilutive securities outstanding on June 30, 2004: (a) options and warrants to purchase an aggregate of 4.2 million shares of common stock at a weighted average exercise price of $15.90 per share and (b) convertible promissory notes that are convertible into an aggregate of 344,000 shares of common stock. These potential dilutive securities were not included in the computation of diluted loss per share for the three and six months ended June 30, 2004 because the effect of including the number of such potential dilutive securities would be antidilutive. We had potential dilutive options and warrants to purchase an aggregate of 994,000 shares of common stock at a weighted average exercise price of $21.53 per share outstandning on June 30, 2003, which were not included in the computation of diluted income per share for the three and six months ended June 30, 2003.

**(6) Series A Redeemable Convertible Preferred Stock**

In January 2004, 208,000 shares of our series A redeemable convertible preferred stock ("Series A Preferred Stock") were converted into 416,000 shares of our common stock. For the six months ended June 30, 2004, we recorded $749,000 in related redemption interest and amortization of beneficial conversion feature, along with the acceleration of the remaining unamortized beneficial conversion feature upon the Series A Preferred Stock conversion.

**(7) Comprehensive Income or Loss**

Comprehensive income or loss represents net income or loss plus other comprehensive income or loss items. Our other comprehensive income or loss includes primarily foreign currency translation adjustments, and to a lesser extent, pension adjustments. For the three and six months ended June 30, 2004, we generated a comprehensive loss of $7.6 million and $10.9 million, respectively, and for the three and six months ended June 30, 2003, we generated comprehensive income of $6.7 million and $8.6 million, respectively.

**(8) 8.75% Senior Subordinated Notes**

On February 10, 2004, we completed the sale of $150.0 million of 8.75% senior subordinated notes (the "Bonds"), due 2012 in a private placement to qualified institutional buyers. Net proceeds from this offering amounted to $145.9 million which was net of underwriters' commissions of $4.1 million. Of the net proceeds, $125.3 million was used to repay all of the outstanding indebtedness and related financing fees under our primary senior credit facility and $9.2 million was used to prepay outstanding 9% subordinated promissory notes and related prepayment penalties. We retained the remaining unused proceeds for Bond offering expenses and general corporate purposes.

The Bonds accrue interest from the date of their issuance, or February 10, 2004, at the rate of 8.75% per year. Interest on the Bonds will be payable semi-annually in arrears on each February 15 and August 15, commencing on August 15, 2004. For the three and six months ended June 30, 2004, we recorded $3.5 million and $5.4 million, respectively, in interest expense, including amortization of deferred financing costs, related to the Bonds. We may redeem the Bonds, in whole or in part, at any time on or after February 15, 2008, at a redemption price equal to 100% of the principal amount plus a premium declining ratably to par, plus accrued and unpaid interest. In addition, prior to February 15, 2007, we may redeem up to 35% of the aggregate principal amount of the Bonds issued with the proceeds of qualified equity offerings at a redemption price equal to 108.75% of the principal amount, plus accrued and unpaid interest.

The Bonds are unsecured and are subordinated in right of payment to all of our existing and future senior debt, including the guarantee of all borrowings under our senior credit facilities. The Bonds are effectively subordinated to all existing and future liabilities, including trade payables, of those subsidiaries that do not guarantee the Bonds.

The Bonds are guaranteed by all of our domestic subsidiaries that are guarantors or borrowers under the senior credit facilities which excludes our subsidiary IVC Industries, Inc. (d/b/a Inverness Medical Nutritionals Group or "IMN") in New Jersey. The guarantees are general unsecured obligations of the guarantors and are subordinated in right of payment to all existing and future senior

debt of the applicable guarantors, which includes their guarantees of, and borrowings under our senior credit facilities. See Note 14 for guarantor financial information.

The indenture governing the Bonds contains covenants that will limit our ability and the ability of our subsidiaries to, among other things, incur additional indebtedness, pay dividends or make other distributions or repurchase or redeem stock, make investments, sell assets, incur liens, enter into agreements restricting our subsidiaries' ability to pay dividends, enter into transactions with affiliates and consolidate, merge or sell all or substantially all of our assets. These covenants are subject to certain exceptions and qualifications.

In connection with the prepayment of the outstanding balances under our primary senior credit facility and 9% subordinated promissory notes, we recorded additional interest expense of $3.8 million for the six months ended June 30, 2004, which consisted of a write-off of the remaining related unamortized deferred financing costs of $3.2 million, a financing fee of $450,000 paid to the banks in connection with our repayment of borrowings under our senior credit facility and a prepayment penalty of $180,000, which equated to 2% of the principal balance repaid under our 9% subordinated promissory notes.

**(9) Business Combinations**

*(a) Recent Acquisitions*

On June 16, 2004, we acquired Advantage Diagnostics Corporation ("ADC"), a closely held lateral flow diagnostic company that specializes in rapid test development and component manufacturing. The purchase price consisted of $2.4 million in cash and $216,000 in assumed debt. The terms of the merger agreement also provide for $1.5 million of contingent consideration payable to the ADC shareholders, upon the successful completion of a new product under development by December 31, 2005.

On June 2, 2004, we acquired Viva Diagnostika ("Viva"), a closely held distributor of professional diagnostic products to the German marketplace. The purchase price of Viva consisted of $2.6 million in cash, 155,000 shares of our common stock with an aggregate fair value of $3.0 million and $295,000 in assumed debt.

Because of the timing of the acquisitions of ADC and Viva, we have not completed third-party valuations of the intangible assets we believe we have acquired. Accordingly, the allocations of the preliminary purchase prices are subject to changes and the aggregate values of the intangible assets have not yet been allocated to the various intangible asset classes on the accompanying consolidated balance sheet as of June 30, 2004.

*(b) Restructuring Plans of Previous Acquisitions*

In connection with our acquisitions of Ostex International, Inc. ("Ostex"), IMN and certain entities, businesses and intellectual property of Unilever Plc (the "Unipath business"), we recorded restructuring costs as part of the respective aggregate purchase prices in accordance with Emerging Issues Task Force ("EITF") Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*. The following table sets forth the restructuring cost balances related to the

restructuring activities of these acquired businesses as of June 30, 2004 and the activities in these accounts during the six months ended June 30, 2004:

| | Balance at December 31, 2003 | Net Costs Added to Purchase Price | Amounts Paid | Other(1) | Balance at June 30, 2004 |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| Ostex | $ 2,086 | $ 309 | $ (717) | $ | $ 1,678 |
| IMN | 519 | | (174) | | 345 |
| Unipath business | 1,347 | | | 22 | 1,369 |
| Total restructuring costs | $ 3,952 | $ 309 | $ (891) | $ 22 | $ 3,392 |

(1) Represents foreign currency translation adjustment.

As a result of our acquisition of Ostex in June 2003, we established a restructuring plan whereby we exited the facilities of Ostex in Seattle, Washington, and combined such activities with our existing manufacturing and distribution facilities. Total severance costs associated with involuntarily terminated employees are $1.6 million, of which substantially all has been paid as of June 30, 2004. Costs to vacate the Ostex facilities are $474,000, of which $119,000 has been paid as of June 30, 2004. Additionally, the remaining costs to exit operations, primarily facilities lease commitments, are $1.9 million, of which $609,000 has been paid as of June 30, 2004.

In connection with our IMN acquisition in March 2002, we reorganized the business operations of IMN to improve efficiencies and eliminate redundant activities on a company-wide basis. The restructuring affected all cost centers within the organization, but most significantly responsibilities at the sales and executive levels, as such activities were combined with our existing business operations. As part of the restructuring plan, we are in the process of relocating one of IMN's warehouses to a closer proximity of the manufacturing facility to improve efficiency. The warehouse relocation is expected to be completed by September 2004. Of the $1.6 million in total exit costs, which include severance costs of involuntarily terminated employees and costs to vacate the warehouse, $1.3 million have been paid as of June 30, 2004.

As a result of our acquisition of the Unipath business in December 2001, we reorganized the operations of the Unipath business for purposes of improving efficiencies and achieving economies of scale on a company-wide basis. Such reorganization affected most major cost centers at the operations of the Unipath England location. Additionally, most business activities of the division in the United States were merged into our existing U.S. businesses. Total exit costs, which primarily related to severance and early retirement obligations, amounted to $4.2 million. As of June 30, 2004, $1.4 million of these exit costs remained unpaid.

**(10) Defined Benefit Pension Plan**

Our subsidiary in England, Unipath Ltd., has a defined benefit pension plan established for certain of its employees. The net periodic benefit costs are as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| | (in thousands) | | | |
| Service cost | $ 446 | $ 337 | $ 900 | $ 670 |
| Interest cost | 51 | 14 | 103 | 28 |
| Expected return on plan assets | (45) | (15) | (91) | (29) |
| Realized losses | 5 | | 11 | |
| Net periodic benefit costs | $ 457 | $ 336 | $ 923 | $ 669 |

**(11) Financial Information by Segment**

Under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision making group is composed of our chief executive officer and members of our senior management. Our reportable operating segments are Consumer Products (comprised of consumer diagnostic products and vitamins and nutritional supplements), Professional Diagnostic Products, and Corporate and Other.

We evaluate performance based on revenue and earnings before taxes.

Segment information for the three and six months ended June 30, 2004 and 2003 is as follows:

| | Consumer Products | Professional Diagnostic Products | Corporate and Other | Total |
|---|---|---|---|---|
| | | (in thousands) | | |
| **Three Months Ended June 30, 2004** | | | | |
| Net revenue from external customers | $ 56,355 | $ 32,372 | $ | $ 88,727 |
| Income (loss) before income taxes (restated) | 1,635 | 689 | (7,622) | (5,298) |
| **Three Months Ended June 30, 2003** | | | | |
| Net revenue from external customers | 48,919 | 16,798 | | 65,717 |
| Income (loss) before income taxes | 4,631 | 1,754 | (12) | 6,373 |
| **Six Months Ended June 30, 2004** | | | | |
| Net revenue from external customers | 117,064 | 62,364 | | 179,428 |
| Income (loss) before income taxes (restated) | 5,640 | 52 | (14,498) | (8,806) |
| **Six Months Ended June 30, 2003 (restated)** | | | | |
| Net revenue from external customers | 97,159 | 33,660 | | 130,819 |
| Income (loss) before income taxes | 10,131 | 3,205 | (3,814) | 9,522 |
| Assets at June 30, 2004 (restated) | 277,549 | 268,463 | 5,070 | 551,082 |
| Assets at December 31, 2003 (restated) | 281,148 | 254,756 | 4,095 | 539,999 |

**(12) Material Contingencies**

Our material pending legal proceedings are described in the section of our annual report on Form 10-K/A for the year ended December 31, 2003 titled "Item 3. Legal Proceedings." Material developments in our material pending legal proceedings are described in this quarterly report on Form 10-Q in "Part II. Item 1. Legal Proceedings."

**(13) Restatements**

In connection with our restatements for the years ended December 31, 2003 and 2002, as discussed in our 2003 annual report on Form 10-K/A, Amendment No. 3, we also restated our previously issued consolidated financial statements as of June 30, 2004 and for the three and six months ended June 30, 2004 and 2003, respectively, to correct an error in the calculation of the provisions for income taxes and the related deferred tax accounts. We should have reported gross, certain deferred tax liabilities associated with temporary differences related to differing tax and book bases of goodwill and other intangible assets. As a result, we have recorded an additional valuation allowance against the deferred tax assets associated with certain net operating loss carry forwards. The correction of this error resulted in incremental non-cash provisions of income taxes in the amount of $641,000 for the second quarter of 2004. In addition, we revised the purchase price allocation in connection with our acquisition of the rapid diagnostic product lines from Abbott Laboratories (the "Abbott business") on September 30, 2003 to attribute $5.7 million to customer related intangible assets acquired in the acquisition. We have also recorded and commenced to amortize as of the date of the acquisition $11.3 million of other assets acquired from Abbott, the amortization of which amounted to approximately $51,000 per quarter, that

we had originally recognized in our Quarterly Report on Form 10-Q for the period ended September 30, 2004. Goodwill generated in connection with the acquisition of the Abbott business is reduced by these amounts. The impact of this revision of the purchase price allocation is to increase amortization expense by $850,000 for the second quarter of 2004. The restatements as a result of the error in the calculation of the provision for income taxes and related deferred tax accounts and the revision of the purchase price allocation in connection with the acquisition of the Abbott business and the resultant incremental amortization are reflected in the amounts below as "as restated."

The following lists the accounts in the consolidated statements of operations and balance sheets that were affected by the aforementioned restatements, with comparisons of the restated amounts to the originally reported amounts and the effect of such restatements on income (loss) from continuing operations, net income (loss) and income (loss) per share. All applicable amounts relating to the aforementioned restatements have been reflected in these consolidated financial statements and notes hereto.

| | Three Months Ended June 30, 2004 | | Three Months Ended June 30, 2003 | |
|---|---|---|---|---|
| | As restated | As reported | As restated | As reported |
| | (in thousands, except per share amounts) | | | |
| Cost of sales | $ 53,723 | $ 53,672 | $ * | $ * |
| Sales and marketing | 13,661 | 12,862 | * | * |
| Income tax provision | 1,759 | 1,118 | 1,152 | 771 |
| Net (loss) income | (7,057) | (5,566) | 5,221 | 5,602 |
| Net (loss) income per common share basic | $ (0.36) | $ (0.28) | $ 0.36 | $ 0.39 |
| Net (loss) income per common share diluted | (0.36) | (0.28) | 0.31 | 0.34 |

| | Six Months Ended June 30, 2004 | | Six Months Ended June 30, 2003 | |
|---|---|---|---|---|
| | As restated | As reported | As restated | As reported |
| | (in thousands, except per share amounts) | | | |
| Cost of sales | $ 107,515 | $ 107,413 | $ * | $ * |
| Sales and marketing | 28,012 | 26,413 | * | * |
| Income tax provision | 1,922 | 640 | 2,389 | 1,627 |
| Net (loss) income | (10,728) | (7,745) | 7,133 | 7,895 |
| Net (loss) income per common share basic | $ (0.59) | $ (0.43) | $ 0.49 | $ 0.54 |
| Net (loss) income per common share diluted | (0.59) | (0.43) | 0.43 | 0.48 |

| | June 30, 2004 | | December 31, 2003 | |
|---|---|---|---|---|
| | As restated | As reported | As restated | As reported |
| | (in thousands) | | | |
| Inventories | $ 55,069 | $ 54,689 | $ 47,423 | $ 47,043 |
| Property, plant and equipment, net | 61,003 | 60,229 | 57,773 | 56,999 |
| Goodwill | 222,527 | 239,586 | 216,733 | 233,792 |
| Other intangible assets with indefinite lives | 50,054 | 41,454 | 46,719 | 38,119 |
| Core Technology and patents, net | 36,845 | 35,428 | 37,942 | 36,423 |
| Other intangible assets, net | 29,837 | 26,500 | 32,679 | 27,743 |
| Deferred tax assets, non-current | 1,130 | 5,031 | 1,456 | 4,075 |
| Accumulated deficit | (84,242) | (77,790) | (72,765) | (69,296) |

All applicable amounts relating to the aforementioned restatements have been reflected in these consolidated financial statements and notes hereto.

*
These accounts were not restated.

**(14) Guarantor Financial Information**

We issued $150 million in Bonds to qualified institutional buyers in reliance on Rule 144A under the Securities Act of 1933, as amended (the "Securities Act"), and outside the United States in compliance with Regulation S of the Securities Act (Note 8). Our payment obligations under the Bonds are guaranteed by certain of our domestic subsidiaries (the "Guarantor Subsidiaries"). The guarantee is full and unconditional. Separate financial statements of the Guarantor Subsidiaries are not presented because we have determined that they would not be material to investors in the Bonds. The following supplemental financial information sets forth, on a consolidating basis, the statements of operations for the three and six months ended June 30, 2004 and 2003, the balance sheets as of June 30, 2004 and December 31, 2003 and the statements of cash flows for the six months ended June 30, 2004 and 2003 for our company (the "Issuer"), the Guarantor Subsidiaries and our other subsidiaries (the "Non-Guarantor Subsidiaries"). The supplemental financial information reflects our investments and the Guarantor Subsidiaries investments in the Guarantor and Non-Guarantor Subsidiaries using the equity method of accounting.

We have extensive transactions and relationships between various members of our consolidated group. These transactions and relationships include intercompany pricing agreements, intellectual property royalty agreements, and general and administrative and research and development cost sharing agreements. Because of these relationships, it is possible that the terms of these transactions are not the same as those that would result from transactions among unrelated third parties.

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF OPERATIONS**
**For the Three Months Ended June 30, 2004**
**(unaudited)**
**(restated)**
**(in thousands)**

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| Net product sales | $ 5,154 | $ 35,639 | $ 56,540 | $ (10,603) | $ 86,730 |
| License revenue | | 24 | 1,973 | | 1,997 |
| **Net revenue** | 5,154 | 35,663 | 58,513 | (10,603) | 88,727 |
| Cost of sales | 4,723 | 25,002 | 35,856 | (11,858) | 53,723 |
| **Gross profit** | 431 | 10,661 | 22,657 | 1,255 | 35,004 |
| Operating expenses: | | | | | |
| Research and development | 4 | 887 | 7,101 | | 7,992 |
| Sales and marketing | 546 | 5,959 | 7,156 | | 13,661 |
| General and administrative | 3,212 | 4,059 | 6,866 | | 14,137 |
| Total operating expenses | 3,762 | 10,905 | 21,123 | | 35,790 |
| **Operating (loss) income** | (3,331) | (244) | 1,534 | 1,255 | (786) |
| Equity in earnings of subsidiaries, net of tax | 272 | | | (272) | |
| Interest expense, including amortization of discounts and write off of deferred financing costs | (3,814) | (368) | (1,321) | 962 | (4,541) |
| Other income (expense), net | 998 | 150 | (157) | (962) | 29 |
| **(Loss) income before income taxes** | (5,875) | (462) | 56 | 983 | (5,298) |
| Income tax provision (benefit) | 1,182 | 960 | (383) | | 1,759 |
| **Net (loss) income** | $ (7,057) | $ (1,422) | $ 439 | $ 983 | $ (7,057) |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF OPERATIONS**
**For the Three Months Ended June 30, 2003**
**(unaudited)**
**(restated)**
**(in thousands)**

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| Net product sales | $ 5,982 | $ 21,372 | $ 48,877 | $ (12,306) | $ 63,925 |
| License revenue | | | 1,792 | | 1,792 |
| **Net revenue** | 5,982 | 21,372 | 50,669 | (12,306) | 65,717 |
| Cost of sales | 4,940 | 13,740 | 29,215 | (10,852) | 37,043 |
| **Gross profit** | 1,042 | 7,632 | 21,454 | (1,454) | 28,674 |
| Operating expenses: | | | | | |
| Research and development | 68 | 153 | 5,736 | | 5,957 |
| Sales and marketing | 565 | 5,181 | 6,411 | | 12,157 |
| General and administrative | 1,759 | 1,285 | 4,966 | | 8,010 |
| Total operating expenses | 2,392 | 6,619 | 17,113 | | 26,124 |
| **Operating (loss) income** | (1,350) | 1,013 | 4,341 | (1,454) | 2,550 |
| Equity in earnings of subsidiaries, net of tax | 3,303 | | | (3,303) | |
| Interest expense, including amortization of discounts | (779) | (282) | (996) | 148 | (1,909) |
| Other income (expense), net | 4,172 | (1,005) | 2,713 | (148) | 5,732 |
| **Income (loss) before income taxes** | 5,346 | (274) | 6,058 | (4,757) | 6,373 |
| Income tax provision | 125 | 438 | 520 | 69 | 1,152 |
| **Net income (loss)** | $ 5,221 | $ (712) | $ 5,538 | $ (4,826) | $ 5,221 |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF OPERATIONS**
**For the Six Months Ended June 30, 2004**
**(unaudited)**
**(restated)**
**(in thousands)**

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| Net product sales | $ 9,929 | $ 69,830 | $ 118,102 | $ (22,930) | $ 174,931 |
| License revenue | | 46 | 4,451 | | 4,497 |
| **Net revenue** | 9,929 | 69,876 | 122,553 | (22,930) | 179,428 |
| Cost of sales | 9,767 | 47,794 | 74,590 | (24,636) | 107,515 |
| **Gross profit** | 162 | 22,082 | 47,963 | 1,706 | 71,913 |
| Operating expenses: | | | | | |
| Research and development | 100 | 1,515 | 13,800 | | 15,415 |
| Sales and marketing | 1,017 | 11,930 | 15,065 | | 28,012 |
| General and administrative | 5,527 | 6,767 | 13,163 | | 25,457 |
| Total operating expenses | 6,644 | 20,212 | 42,028 | | 68,884 |
| **Operating (loss) income** | (6,482) | 1,870 | 5,935 | 1,706 | 3,029 |
| Equity in earnings of subsidiaries, net of tax | 1,236 | | | (1,236) | |
| Interest expense, including amortization of discounts and write off of deferred financing costs | (6,987) | (4,038) | (2,889) | 1,603 | (12,311) |
| Other income, net | 1,729 | 246 | 104 | (1,603) | 476 |
| **(Loss) income before income taxes** | (10,504) | (1,922) | 3,150 | 470 | (8,806) |
| Income tax provision | 224 | 1,233 | 465 | | 1,922 |
| **Net (loss) income** | $ (10,728) | $ (3,155) | $ 2,685 | $ 470 | $ (10,728) |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF OPERATIONS**
**For the Six Months Ended June 30, 2003**
**(unaudited)**
**(restated)**
**(in thousands)**

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| Net product sales | $ 11,719 | $ 44,333 | $ 91,480 | $ (20,628) | $ 126,904 |
| License revenue | | 31 | 3,884 | | 3,915 |
| **Net revenue** | 11,719 | 44,364 | 95,364 | (20,628) | 130,819 |
| Cost of sales | 9,430 | 27,252 | 56,017 | (20,384) | 72,315 |
| **Gross profit** | 2,289 | 17,112 | 39,347 | (244) | 58,504 |
| Operating expenses: | | | | | |
| Research and development | 137 | 279 | 10,226 | | 10,642 |
| Sales and marketing | 1,118 | 10,561 | 12,019 | | 23,698 |
| General and administrative | 3,556 | 2,496 | 10,324 | | 16,376 |
| Stock-based compensation | 6 | | | | 6 |
| Total operating expenses | 4,817 | 13,336 | 32,569 | | 50,722 |
| **Operating (loss) income** | (2,528) | 3,776 | 6,778 | (244) | 7,782 |
| Equity in earnings of subsidiaries, net of tax | 7,354 | | | (7,354) | |
| Interest expense, including amortization of discounts | (1,965) | (588) | (2,023) | 296 | (4,280) |
| Other income (expense), net | 4,522 | (976) | 2,770 | (296) | 6,020 |
| **Income before income taxes** | 7,383 | 2,212 | 7,525 | (7,598) | 9,522 |
| Income tax provision | 250 | 903 | 1,051 | 185 | 2,389 |
| **Net income** | $ 7,133 | $ 1,309 | $ 6,474 | $ (7,783) | $ 7,133 |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING BALANCE SHEET**
**June 30, 2004**
**(unaudited)**
**(restated)**
**(in thousands)**

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current Assets:** | | | | | |
| Cash and cash equivalents | $ 458 | $ 9,389 | $ 12,148 | $ | $ 21,995 |
| Accounts receivable, net of allowances | 2,063 | 25,690 | 25,632 | | 53,385 |
| Inventories | 5,531 | 18,423 | 35,732 | (4,617) | 55,069 |
| Deferred tax assets | | | 1,178 | | 1,178 |
| Prepaid expenses and other current assets | 1,767 | 1,497 | 5,883 | | 9,147 |
| Intercompany receivables | 56,412 | 14,291 | 14,791 | (85,494) | |
| **Total current assets** | 66,231 | 69,290 | 95,364 | (90,111) | 140,774 |
| Property, plant and equipment, net | 2,475 | 10,894 | 47,634 | | 61,003 |
| Goodwill | 30,505 | 95,404 | 96,618 | | 222,527 |
| Other intangible assets with indefinite lives | | 12,420 | 37,634 | | 50,054 |
| Core technology and patents, net | 2,689 | 5,915 | 28,241 | | 36,845 |
| Other intangible assets, net | 5,194 | 15,647 | 8,996 | | 29,837 |
| Deferred financing costs, net, and other non-current assets | 6,314 | 1,539 | 1,059 | | 8,912 |
| Deferred tax assets | (520) | (1,629) | 2,821 | 458 | 1,130 |
| Investment in subsidiaries | 232,343 | (716) | | (231,627) | |
| Intercompany notes receivable | 119,152 | 14,263 | | (133,415) | |
| **Total assets** | $ 464,383 | $ 223,027 | $ 318,367 | $ (454,695) | $ 551,082 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | | | |
| **Current liabilities:** | | | | | |
| Current portion of long-term debt | $ | $ | $ 1,519 | $ | $ 1,519 |
| Current portion of capital lease obligations | | 2 | 458 | | 460 |
| Accounts payable | 784 | 8,846 | 22,489 | | 32,119 |
| Accrued expenses and other current liabilities | 12,259 | 14,114 | 20,974 | | 47,347 |
| Intercompany payables | 11,232 | 15,366 | 58,896 | (85,494) | |
| **Total current liabilities** | 24,275 | 38,328 | 104,336 | (85,494) | 81,445 |
| **Long-term liabilities:** | | | | | |
| Long-term debt, net of current portion | 175,156 | | 12,855 | | 188,011 |
| Capital lease obligations, net of current portion | | 6 | 1,587 | | 1,593 |
| Deferred tax liabilities | | 1,753 | 9,743 | | 11,496 |
| Other long-term liabilities | | | 3,585 | | 3,585 |
| Intercompany notes payable | | 68,139 | 65,226 | (133,365) | |
| **Total long-term liabilities** | 175,156 | 69,898 | 92,996 | (133,365) | 204,685 |

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Stockholders' equity** | 264,952 | 114,801 | 121,035 | (235,836) | 264,952 |
| **Total liabilities and stockholders' equity** | $ 464,383 | $ 223,027 | $ 318,367 | $ (454,695) | $ 551,082 |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING BALANCE SHEET**
**December 31, 2003**
**(restated)**
**(in thousands)**

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current Assets:** | | | | | |
| Cash and cash equivalents | $ 1,708 | $ 11,058 | $ 11,856 | $ | $ 24,622 |
| Accounts receivable, net of allowances | 3,915 | 29,505 | 21,998 | | 55,418 |
| Inventories | 4,463 | 19,737 | 29,360 | (6,137) | 47,423 |
| Deferred tax assets | | | 1,178 | | 1,178 |
| Prepaid expenses and other current assets | 1,365 | 1,507 | 7,727 | | 10,599 |
| Intercompany receivables | 6,073 | 11,785 | 8,911 | (26,769) | |
| **Total current assets** | 17,524 | 73,592 | 81,030 | (32,906) | 139,240 |
| Property, plant and equipment, net | 1,199 | 10,405 | 46,169 | | 57,773 |
| Goodwill | 48,704 | 73,188 | 94,841 | | 216,733 |
| Other intangible assets with indefinite lives | | 9,092 | 37,627 | | 46,719 |
| Core technology and patents, net | 8,193 | 293 | 29,456 | | 37,942 |
| Other intangible assets, net | 6,437 | 15,400 | 10,842 | | 32,679 |
| Deferred financing costs, net, and other non-current assets | 2,015 | 4,150 | 1,292 | | 7,457 |
| Deferred tax assets | (295) | (571) | 2,322 | | 1,456 |
| Investment in subsidiaries | 204,553 | | | (204,553) | |
| Intercompany notes receivable | 120,918 | 94,208 | | (215,126) | |
| **Total assets** | $ 409,248 | $ 279,757 | $ 303,579 | $ (452,585) | $ 539,999 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | | | |
| **Current liabilities:** | | | | | |
| Current portion of long-term debt | $ | $ | $ 14,055 | $ | $ 14,055 |
| Current portion of capital lease obligations | | 18 | 439 | | 457 |
| Accounts payable | 4,448 | 11,431 | 22,127 | | 38,006 |
| Accrued expenses and other current liabilities | 8,641 | 14,879 | 17,602 | | 41,122 |
| Intercompany payables | 6,512 | 8,036 | 12,226 | (26,774) | |
| **Total current liabilities** | 19,601 | 34,364 | 66,449 | (26,774) | 93,640 |
| **Long-term liabilities:** | | | | | |
| Long-term debt, net of current portion | 34,056 | 91,974 | 33,808 | | 159,838 |
| Capital lease obligations, net of current portion | | 20 | 1,811 | | 1,831 |
| Deferred tax liabilities | | 1,752 | 7,366 | | 9,118 |
| Other long-term liabilities | | | 3,307 | | 3,307 |
| Intercompany notes payable | 83,326 | 57,186 | 74,611 | (215,123) | |
| **Total long-term liabilities** | 117,382 | 150,932 | 120,903 | (215,123) | 174,094 |

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Series A redeemable convertible preferred stock** | 6,185 | | | | 6,185 |
| **Stockholders' equity** | 266,080 | 94,461 | 116,227 | (210,688) | 266,080 |
| **Total liabilities and stockholders' equity** | $ 409,248 | $ 279,757 | $ 303,579 | $ (452,585) | $ 539,999 |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF CASH FLOWS**
**For the Six Months Ended June 30, 2004**
**(unaudited)**
**(restated)**
**(in thousands)**

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | | | |
| Net (loss) income | $ (10,728) | $ (3,155) | $ 2,685 | $ 470 | $ (10,728) |
| Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities: | | | | | |
| Equity in earnings of subsidiaries, net of tax | (1,236) | | | 1,236 | |
| Interest expense related to amortization and/or write-off of non-cash original issue discount, and deferred financing costs | 548 | 3,064 | 348 | | 3,960 |
| Noncash gain related to interest rate swap agreement | (434) | | | | (434) |
| Depreciation and amortization | 818 | 2,371 | 8,190 | | 11,379 |
| Deferred income taxes | 224 | 1,058 | | | 1,282 |
| Other noncash items | | (46) | (33) | | (79) |
| Changes in assets and liabilities, net of acquisitions: | | | | | |
| Accounts receivable, net | 1,852 | 2,968 | (2,251) | | 2,569 |
| Inventories | (1,068) | 1,385 | (5,270) | (1,706) | (6,659) |
| Prepaid expenses and other current assets | (403) | (3) | 1,836 | | 1,430 |
| Intercompany payables or receivables | (123,714) | 90,763 | 32,794 | 157 | |
| Accounts payable | (3,666) | (2,641) | (201) | | (6,508) |
| Accrued expenses and other current liabilities | 6,550 | (1,006) | 3,990 | | 9,534 |
| Increase in other long-term liabilities | | | 302 | | 302 |
| **Net cash (used in) provided by operating activities** | (131,257) | 94,758 | 42,390 | 157 | 6,048 |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF CASH FLOWS (continued)**
**For the Six Months Ended June 30, 2004**
**(unaudited)**
**(restated)**
**(in thousands)**

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Cash Flows from Investing Activities:** | | | | | |
| Purchases of property, plant and equipment | (1,383) | (2,675) | (5,867) | | (9,925) |
| Proceeds from sale of property, plant and equipment | | 123 | 59 | | 182 |
| Payments for acquisitions | (4,633) | (926) | (2,927) | | (8,486) |
| (Increase) decrease in other assets | (759) | (612) | 577 | | (794) |
| **Net cash used in investing activities** | (6,775) | (4,090) | (8,158) | | (19,023) |
| **Cash Flows from Financing Activities:** | | | | | |
| Cash paid for financing costs | (4,764) | (325) | (28) | | (5,117) |
| Proceeds from issuance of common stock, net of issuance costs | 546 | | | | 546 |
| Proceeds from issuance of senior subordinated notes | 150,000 | | | | 150,000 |
| Net repayment under revolving lines of credit | | (16,899) | (23,059) | | (39,958) |
| Repayments of notes payable | (9,000) | (75,075) | (10,430) | | (94,505) |
| Principal payments of capital lease obligations | | (38) | (204) | | (242) |
| **Net cash provided by (used in) financing activities** | 136,782 | (92,337) | (33,721) | | 10,724 |
| Foreign exchange effect on cash and cash equivalents | | | (219) | (157) | (376) |
| **Net (decrease) increase in cash and cash equivalents** | (1,250) | (1,669) | 292 | | (2,627) |
| **Cash and cash equivalents, beginning of period** | 1,708 | 11,058 | 11,856 | | 24,622 |
| **Cash and cash equivalents, end of period** | $ 458 | $ 9,389 | $ 12,148 | $ | $ 21,995 |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF CASH FLOWS**
**For the Six Months Ended June 30, 2003**
**(unaudited)**
**(restated)**
**(in thousands)**

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | | | |
| Net income | $ 7,133 | $ 1,309 | $ 6,474 | $ (7,783) | $ 7,133 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | | | |
| Equity in earnings of subsidiaries, net of tax | (7,352) | | | 7,352 | |
| Interest expense related to amortization of noncash original issue discount and deferred financing costs | 228 | 136 | 284 | | 648 |
| Noncash gain related to interest rate swap agreement | (87) | | | | (87) |
| Noncash stock-based compensation expense | 6 | | | | 6 |
| Depreciation and amortization | 297 | 1,303 | 5,451 | | 7,051 |
| Deferred income taxes | 224 | 538 | 366 | 185 | 1,313 |
| Other noncash items | | (25) | 23 | | (2) |
| Changes in assets and liabilities, net of acquisitions: | | | | | |
| Accounts receivable, net | (510) | (1,512) | 1,190 | | (832) |
| Inventories | (224) | 1,683 | (5,073) | 246 | (3,368) |
| Prepaid expenses and other current assets | (549) | 862 | (2,455) | | (2,142) |
| Intercompany payables or receivables | 6,158 | (5,183) | (327) | (648) | |
| Accounts payable | (831) | (1,106) | 200 | | (1,737) |
| Accrued expenses and other current liabilities | 597 | (2,604) | (4,290) | | (6,297) |
| **Net cash provided by (used in) operating activities** | 5,090 | (4,599) | 1,843 | (648) | 1,686 |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF CASH FLOWS (continued)**
**For the Six Months Ended June 30, 2003**
**(unaudited)**
**(restated)**
**(in thousands)**

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Cash Flows from Investing Activities:** | | | | | |
| Purchases of property, plant and equipment | (176) | (963) | (4,416) | | (5,555) |
| Proceeds from sale of property, plant and equipment | | 64 | 79 | | 143 |
| Payments for acquisitions and intellectual property | (3,029) | (276) | (916) | | (4,221) |
| (Increase) decrease in other assets | (441) | (193) | 41 | | (593) |
| **Net cash used in investing activities** | (3,646) | (1,368) | (5,212) | | (10,226) |
| **Cash Flows from Financing Activities:** | | | | | |
| Cash paid for financing costs | (93) | | (19) | | (112) |
| Proceeds from issuance of common stock, net of issuance costs | 809 | | | | 809 |
| Net proceeds from lines of credit | | | 2,313 | | 2,313 |
| Repayments of notes payable | | (1,250) | (1,401) | | (2,651) |
| Principal payments of capital lease obligations | | | (340) | | (340) |
| **Net cash provided by (used in) financing activities** | 716 | (1,250) | 553 | | 19 |
| Foreign exchange effect on cash and cash equivalents | | | 2,225 | 648 | 2,873 |
| **Net increase (decrease) in cash and cash equivalents** | 2,160 | (7,217) | (591) | | (5,648) |
| **Cash and cash equivalents, beginning of period** | 3,004 | 16,069 | 11,595 | | 30,668 |
| **Cash and cash equivalents, end of period** | $ 5,164 | $ 8,852 | $ 11,004 | $ | $ 25,020 |

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Forward-Looking Statements**

As noted above, this quarterly report on Form 10-Q, including this Item 2, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements in this Item 2 include, without limitation, statements regarding our expectations with respect to new product launches, research and development expenditures, legal expenditures, net product sales and gross profits from our various business segments, license revenue, our funding plans for our future working capital needs and commitments, and the impact of our acquisitions. Actual results or developments could differ materially from those projected in such statements as a result of numerous factors, including, without limitation, those risks and uncertainties set forth below under "Certain Factors Affecting Future Results" and "Special Statement Regarding Forward-Looking Statements." The following discussion and analysis of our financial condition and results of operations should be read in light of those risks and uncertainties and in conjunction with our accompanying consolidated financial statements and notes thereto.

**Overview**

We are a leading global developer, manufacturer and marketer of in vitro diagnostic products for the over-the-counter pregnancy and fertility/ovulation test market and the professional rapid diagnostic test market. In addition, we manufacture a variety of vitamins and nutritional supplements that we market under our brands and those of private label retailers in the consumer market primarily in the United States.

Our business is organized into two primary segments, consumer products and professional diagnostic products. The consumer products segment includes our over-the-counter pregnancy and fertility/ovulation tests and vitamins and nutritional supplements. The professional diagnostic products segment includes an array of innovative rapid diagnostic test products and other in vitro diagnostic tests marketed to medical professionals and laboratories for detection of infectious diseases, drugs of abuse and pregnancy.

For the three and six months ended June 30, 2004, we recorded net revenue of $88.7 million and $179.4 million, respectively, compared to net revenue of $65.7 million and $130.8 million for the three and six months ended June 30, 2003, respectively. Adjusted for the impact of currency translation, net revenue for the three and six months ended June 30, 2004 was $86.5 million and $174.1 million, respectively. Overall revenue growth, adjusted for the impact of currency translation, resulted from acquisitions and, to a lesser extent, organic growth, both of which occurred primarily in our professional diagnostics business. Our acquisitions in the second half of 2003, including the rapid diagnostics product lines from Abbott Laboratories in September and Applied Biotech, Inc., or ABI, in August, contributed approximately 77% of our currency adjusted revenue growth for the six months ended June 30, 2004.

Despite the growth in our revenue, for the three and six months ended June 30, 2004, we recorded a net loss of $7.1 million and $10.7 million, respectively, compared to net income of $5.2 million and $7.1 million for the three and six months ended June 30, 2003, respectively. Factors that contributed to the significant loss in 2004 through June, as compared to the income in the comparable period of 2003, include (i) reduction of approximately 160 basis points in our overall gross margin due to fluctuations in foreign currencies that are unfavorable to our core pregnancy product margins, (ii) reduction of approximately 200 basis points in our overall gross margin due to margin erosion in our nutritionals business, (iii) significant research and development spending, (iv) higher interest expense due to higher average debt balance and weighted average interest rate primarily resulted from our decision to

refinance our debt in February 2004, and (v) the recording of a reserve for potential bad debt and unsaleable inventory totaling $1.5 million. Additionally, the income recorded for the three and six months ended June 30, 2003 included a one-time recording of income of $3.8 million from a settlement with Unilever Plc in the second quarter of 2003 and $1.2 million in past royalties received as part of a patent infringement settlement in May 2003, both of which were recorded in other income in the consolidated statements of operations in those periods.

As a leading global developer of advanced diagnostic devices, we are continually exploring opportunities in a variety of professional diagnostic and consumer-oriented applications, including immuno-diagnostics with a focus on women's health, cardiology and infectious disease. We have recently executed several new point-of-care national distribution agreements and launched a new Clinical Laboratories Improvement Act of 1988 ("CLIA") waived strep throat test, and we expect to introduce tests for D-Dimer, Fecal Occult Blood and HIV in the second half of 2004 and a pro-thrombin meter in the first quarter of 2005. Our emphasis on new product development requires substantial investment and involves significant inherent risk. We intend to continue our robust research and development expenditures. In addition, we will continue to aggressively defend our substantial intellectual property portfolio, which underlies our emphasis on new product development, against potential infringers. The risks arising from our emphasis and reliance on new product development and intellectual property, as well as the other numerous risks that our business faces, including the risks associated with our substantial indebtedness and our acquisitions, are set forth in the section titled "Certain Factors Affecting Future Results" beginning on page 44 of this report.

**Recent Developments**

*Preliminary Injunction Granted Against Acon Laboratories*

On July 16, 2004, the United States District Court for the District of Massachusetts granted our motion for a preliminary injunction against Acon Laboratories, Inc. Acon sells various immunoassay products throughout the world and is a supplier of private label consumer diagnostics products (including sandwich-type immunoassay tests for strep, pregnancy and ovulation) to major retailers and other distributors. In the Memorandum and Order issued on July 16, 2004, the Court also granted our motion for summary judgment of infringement, finding that Acon's sandwich-type immunoassay tests infringe Claims 7 and 19 of U.S. Patent No. 6,485,982 (the "982 patent"). In addition, the Court denied Acon's motion for summary judgment of invalidity of Claims 7 and 19 and found that on the basis of the record before the Court, we had shown that we were likely to succeed in our arguments against Acon's invalidity contentions. The Court's order notes that certain issues relating to Acon's challenge to the validity of the claims can be heard at trial. The preliminary injunction will issue only after we post a bond, the amount of which has yet to be determined by the Court, and is expected to cover all unlicensed sales by Acon of sandwich-type immunoassay devices in the United States. Acon has moved for reconsideration of the Court's injunction decision and has also submitted information to the Court concerning their proposed amount of the bond in light of a limited license that it has obtained from the owner of the '982 Patent, Church & Dwight Co., covering certain over-the-counter sales of immunoassays through one U.S. distributor solely for re-sale to certain customers. We will oppose the motion for reconsideration and press for prompt issuance of the injunction. Under the scheduling order currently in place, a trial on remaining issues in the case concerning the '982 patent is scheduled for early November 2004.

**Restatements**

In connection with our restatements for the years ended December 31, 2003 and 2002, as discussed in our 2003 annual report on Form 10-K/A, Amendment No. 3, we also restated our consolidated financial statements for the three and six months ended June 30, 2004 and 2003, respectively, to reflect corrections to our income tax provisions as well as revisions to the purchase price allocation in

connection with our acquisition of the Abbott business on September 30, 2003 (and the resulting additional non cash amortization). Such adjustments are reflected in the accompanying consolidated interim financial information for the three and six months ended June 30, 2004 and 2003, respectively, and discussed in Note 13 hereto.

**Results of Operations**

**Net Product Sales.** Net product sales increased by $22.8 million, or 36%, to $86.7 million for the three months ended June 30, 2004 from $63.9 million for the three months ended June 30, 2003. Net product sales increased by $48.0 million, or 38%, to $174.9 million for the six months ended June 30, 2004 from $126.9 million for the six months ended June 30, 2003. Adjusted for the favorable impact of currency translation on our foreign operations, net product sales in the three and six months ended June 30, 2004 grew by approximately $20.6 million, or 32%, and $42.7 million, or 34%, respectively, compared to the same periods in 2003. The majority of the product sales increase, comparing the three and six months ended June 30, 2004 to the three and six months ended June 30, 2003, resulted from the businesses we acquired in the second half of 2003: (i) the rapid diagnostic product lines from Abbott, which contributed $9.7 million and $19.6 million of such increase in the respective periods, and (ii) ABI, which contributed $5.6 million and $11.9 million of such increase in the respective periods. The growth in our professional diagnostics base business, as discussed below, also contributed to the increase in currency adjusted net product sales, comparing the three months ended June 30, 2004 to the same period in 2003. Further, the launch of our Clearblue Easy Digital pregnancy test in June 2003 and the commencement of our supply of the digital version of Pfizer's e.p.t pregnancy test in December 2003 and the visual version of Pfizer's e.p.t pregnancy test in June 2004, contributed to the currency adjusted net product sales increase, comparing the six months ended June 30, 2004 to the same period in 2003.

**Net Product Sales by Business Segment.** Net product sales by business segment for the three and six months ended June 30, 2004 and 2003, respectively, are as follows:

| | Three Months ended June 30, | | | Six Months ended June 30, | | |
|---|---|---|---|---|---|---|
| | 2004 | 2003 | % Increase | 2004 | 2003 | % Increase |
| | | | | | (restated) | |
| | | | (in thousands) | | | |
| Consumer products | $ 55,009 | $ 47,525 | 16% | $ 114,049 | $ 94,131 | 21% |
| Professional diagnostic products | 31,721 | 16,400 | 93% | 60,882 | 32,773 | 86% |
| Total net product sales | $ 86,730 | $ 63,925 | 36% | $ 174,931 | $ 126,904 | 38% |

The currency adjusted increase in net product sales from our consumer products, which includes our consumer diagnostic products and our vitamins and nutritional supplements, was $5.3 million and $14.6 million, comparing the three and six months ended June 30, 2004, respectively, to the same periods in 2003. Of the currency adjusted increase in the three- and six-month period comparison, $2.8 million and $5.2 million, respectively, resulted from our acquisition of Abbott's Fact plus line of consumer diagnostic pregnancy tests. The acquisition of ABI contributed $0.7 million and $1.2 million of the currency adjusted increase in the three- and six-month period comparison, respectively. We expect net product sales from our consumer products to increase for the remainder of 2004, as we commenced supplying the visual e.p.t pregnancy tests to Pfizer and shipping our digital ovulation test late in the second quarter of 2004.

The increase in net product sales from our professional diagnostic products was $15.3 million and $28.1 million, comparing the three and six months ended June 30, 2004, respectively, to the same periods in 2003. Our acquisition of the Abbott TestPack, Abbott TestPack plus and Signify product lines from Abbott contributed $6.9 million and $14.4 million, respectively, of the increase in the three- and

six-month period comparison. Our acquisition of ABI contributed $4.9 million and $10.7 million, respectively, of the increase in the three- and six-month period comparison. The remaining increase in net product sales from our professional diagnostic products primarily resulted from our organic growth. We expect our organic professional diagnostics business to continue to grow as we recently signed several new point-of-care national distribution agreements and as we plan to introduce new products, such as tests for D-Dimer, Fecal Occult Blood, HIV and a CLIA waived strep throat test, during the second half of 2004.

**License Revenue.** License revenue represents license and royalty fees from intellectual property license agreements with third-parties. License revenue increased by $0.2 million, or 11%, to $2.0 million for the three months ended June 30, 2004 from $1.8 million for the three months ended June 30, 2003 and by $0.6 million, or 15%, to $4.5 million for the six months ended June 30, 2004 from $3.9 million for the six months ended June 30, 2003. The increases are a function of the net results of royalties collected under new licenses and decrease in royalties under expired licenses. We expect license revenue for the remainder of 2004 to decrease, compared to the first half of the year, as we will cease collection of royalty fees from Pfizer during the third quarter of 2004, that we have been collecting since June 2003 as part of the settlement of our infringement litigation against it because we recently commenced the supply of Pfizer's visual e.p.t pregnancy test.

**Gross Profit and Margin.** Gross profit increased by $6.3 million, or 22%, to $35.0 million for the three months ended June 30, 2004 from $28.7 million for the three months ended June 30, 2003. Gross profit increased by $13.4 million, or 23%, to $71.9 million for the six months ended June 30, 2004 from $58.5 million for the six months ended June 30, 2003. The gross profit increase, comparing the three and six months ended June 30, 2004 to the three and six months ended June 30, 2003, resulted from the businesses that we acquired in the second half of 2003: (i) the rapid diagnostic product lines from Abbott, which contributed $4.9 million and $9.8 million of such increase in the respective periods, and (ii) ABI, which contributed $1.8 million and $3.8 million of such increase. Although organic growth, primarily the launch of our Clearblue Easy Digital pregnancy test in June 2003, the commencement of our supply of the digital version of Pfizer's e.p.t pregnancy test in December 2003 and the growth in our professional diagnostics base business, also contributed to the increase in our overall gross profit, such increases were offset by declining profits from our nutritional supplements business. Gross profit from our nutritional supplements business principally the private label business, declined by $1.8 million and $2.5 million, comparing the three and six months ended June 30, 2004 to the three and six months ended June 30, 2003, respectively, while sales of nutritional supplements increased. Our private label nutritional supplements business has suffered from excess capacity in the industry which led to increasing price competition.

Overall gross margin was 40% for both the three and six months ended June 30, 2004 compared to 44% and 45% for the three and six months ended June 30, 2003, respectively. Gross margin was adversely impacted in 2004 by the continuing weak U.S. Dollar against the Euro and British Pound Sterling. Such movements in foreign exchange currencies negatively impacted the gross margin percentage of our products manufactured at our European subsidiaries and sold in U.S. Dollars. This currency impact had the effect of reducing gross margins by 112 and 158 basis points, comparing the three and six months ended June 30, 2004 to the three and six months ended June 30, 2003, respectively. Further, due to competitive pricing in the nutritional supplements business, gross margin from our nutritional supplements sales, principally in our private label business, has declined significantly. For the three and six months ended June 30, 2004, as compared to the same periods in 2003, the margin erosion of the nutritional supplements business affected our overall gross margin by 212 and 190 basis points, respectively. Lastly, the decline in overall gross margin resulted from the ABI products, which on average have been generating lower gross margins than our other products. The effect on overall gross margin from the addition of the ABI products was a reduction by 44 and 55 basis points for the three and six months ended June 30, 2004, respectively.

**Gross Profit from Net Product Sales by Business Segment.** Gross profit from net product sales represents total gross profits less gross profits associated with license revenue. Gross profit from total net product sales increased by $6.1 million, or 22%, to $33.8 million for the three months ended June 30, 2004 from $27.7 million for the three months ended June 30, 2003. Gross profit from total net product sales increased by $12.9 million, or 23%, to $69.1 million for the six months ended June 30, 2004 from $56.1 million for the six months ended June 30, 2003. Gross profit from net product sales by business segment for the three and six months ended June 30, 2004 and 2003, respectively, are as follows:

| | Three Months ended June 30, | | | Six Months ended June 30, | | |
|---|---|---|---|---|---|---|
| | 2004 | 2003 | % Increase | 2004 | 2003 | % Increase |
| | (restated) | | | (restated) | (restated) | |
| | (in thousands) | | | | | |
| Consumer products | $ 21,458 | $ 20,449 | 5% | $ 45,358 | $ 42,351 | 7% |
| Professional diagnostic products | 12,390 | 7,212 | 73% | 23,714 | 13,796 | 73% |
| Total gross profit from net product sales | $ 33,848 | $ 27,661 | 22% | $ 69,072 | $ 56,147 | 23% |

The increase in gross profit from our consumer product sales, comparing the three and six months ended June 30, 2004 to the same periods in 2003, resulted from our acquisition of Abbott's Fact plus line of consumer diagnostic pregnancy tests in September 2003. For the three and six months ended June 30, 2004, the Fact plus product line generated gross profit of $1.5 million and $2.8 million, respectively. Although organic growth, primarily the launch of our Clearblue Easy Digital pregnancy test in June 2003 and the commencement of our supply of the digital version of Pfizer's e.p.t pregnancy test in December 2003 and the visual version of Pfizer's e.p.t pregnancy test in June 2004, also contributed to the increase in our gross profit from our consumer product sales, such increases were offset by declining profits from our nutritional supplements business. Gross profit from our nutritional supplements business principally the private label business, declined by $1.8 million and $2.5 million, comparing the three and six months ended June 30, 2004 to the three and six months ended June 30, 2003, respectively, while sales of nutritional supplements increased. We expect gross profit from our consumer product sales to increase in the remainder of 2004, as we continue to supply Pfizer's digital and visual e.p.t pregnancy tests.

Gross margin from our consumer product sales was 39% and 40% for the three and six months ended June 30, 2004, respectively, compared to 43% and 45% for the three and six months ended June 30, 2003, respectively. The movements in foreign currencies, comparing the three and six months ended June 30, 2004 to the three and six months ended June 30, 2003, negatively impacted the gross margin by 181 and 249 basis points, respectively, for our consumer products manufactured at our European subsidiaries and sold in U.S. Dollars. Additionally, our nutritional supplements business, principally the private label business, suffered margin erosion due to pricing competition. For the three and six months ended June 30, 2004, as compared to the same periods in 2003, the margin erosion of the nutritional supplements business affected our overall gross margin by 343 and 299 basis points, respectively. The negative impact of foreign currency movements and margin erosion of our nutritional supplements business was slightly offset by the sales of our Clearblue Easy Digital pregnancy test, which has been generating a higher margin as compared to the average margin of our other consumer products.

The increase in gross profit from our professional diagnostic product sales, comparing the three and six months ended June 30, 2004 to the same periods in 2003, primarily resulted from our acquisitions of the Abbott TestPack, Abbott TestPack plus and Signify product lines from Abbott and ABI. The Abbott professional diagnostic products generated $3.4 million and $7.1 million in gross

profit for the three and six months ended June 30, 2004, respectively. The ABI products generated $1.7 million and $3.7 million gross profit for the three and six months ended June 30, 2004, respectively.

Gross margin from our professional diagnostic product sales was 39% for both the three and six months ended June 30, 2004 compared to 44% and 42% for the three and six months ended June 30, 2003, respectively. The decline in gross margin of our professional diagnostic products primarily resulted from the ABI products which on average have been generating lower margins than our other professional products. The effect on gross margin from our professional diagnostic products from the addition of the ABI products was a reduction by 133 and 164 basis points for the three and six months ended June 30, 2004, respectively.

**Research and Development Expense.** Research and development expense increased by $2.0 million, or 33%, to $8.0 million for the three months ended June 30, 2004 from $6.0 million for the three months ended June 30, 2003. Research and development expense increased by $4.8 million, or 45%, to $15.4 million for the six months ended June 30, 2004 from $10.6 million for the six months ended June 30, 2003. A significant portion of our research and development spending occurs at our facilities in the U.K. As a result, the weak U.S. Dollar against the Pounds Sterling causes an increase in the dollar value of research and development expense at translation. Adjusted for the unfavorable impact of currency translation, research and development expense in the three and six months ended June 30, 2004 increased by approximately $1.4 million, or 23%, and $3.4 million, or 32%, respectively, compared to the same periods in 2003. Our acquisitions of Ostex and ABI, primarily in the field of osteoporosis and professional diagnostic testing, contributed $0.5 million and $1.0 million of the currency adjusted increase in research and development expense, comparing the three and six months ended June 30, 2004 to the same periods in 2003, respectively. The remaining currency adjusted increase in research and development expense of $0.9 million and $2.4 million, comparing the three and six months ended June 30, 2004 to the same periods in 2003, respectively, primarily related to our continued significant investment in the development of products in the field of cardiology, including a pro-thrombin test, scheduled for launch in the first quarter of 2005, and a congestive heart failure product which remains on track for launch in late 2005. For factors that may impact our ability to meet our expectations to launch these products, see "Certain Factors Affecting Future Results."

**Sales and Marketing Expense.** Sales and marketing expense increased by $1.5 million, or 12%, to $13.7 million for the three months ended June 30, 2004 from $12.2 million for the three months ended June 30, 2003. Sales and marketing expense increased by $4.3 million, or 18%, to $28.0 million for the six months ended June 30, 2004 from $23.7 million for the six months ended June 30, 2003. A significant portion of our sales and marketing spending occurs at our European subsidiaries. Therefore, and as a result of the continued weak U.S. Dollar, the currency adjusted increase in sales and marketing expense, comparing the three and six months ended June 30, 2004 to the same periods in 2003, was $1.1 million and $3.0 million, respectively. The currency adjusted increase in sales and marketing expense primarily resulted from our various acquisitions since June 2003, particularly as a result of amortization of acquired customer related intangible assets.

Sales and marketing expense as a percentage of net product sales decreased to 16% for both the three and six months ended June 30, 2004 from 19% for both the three and six months ended June 30, 2003, which primarily resulted from the shift to our professional diagnostics business which generally incur lower sales and marketing expense as a percentage of sales compared to our consumer products business.

**General and Administrative Expense.** General and administrative expense increased by $6.1 million, or 76%, to $14.1 million for the three months ended June 30, 2004 from $8.0 million for the three months ended June 30, 2003. General and administrative expense increased by $9.1 million, or 55%, to $25.5 million for the six months ended June 30, 2004 from $16.4 million for the six months

ended June 30, 2003. Included in general and administrative expense for the three and six months ended June 30, 2004 was the establishment of a specific reserve for a doubtful accounts receivable balance of $1.4 million associated with a private label customer that failed to perform under the terms of our agreement during the second quarter of 2004 and is now the subject of legal action which commenced in July 2004. Further, of the increase in general and administrative expense, comparing the three and six months ended June 30, 2004 to the same periods in 2003, $1.7 million and $3.3 million, respectively, resulted from our acquisitions since June 2003. Additionally, we continued to litigate in support of our intellectual property rights, resulting in an increase in legal expenses of $1.0 million and $0.3 million, comparing the three and six months ended June 30, 2004 to the same periods in 2003, respectively. Also, a portion of the increase in general and administrative expense resulted from our investment in increased management in the second half of 2003. Incremental salaries and fringe benefits related to investment in management personnel for the three and six months ended June 30, 2004 amounted to approximately $0.4 million and $0.7 million, respectively. The foreign exchange translation impact due to the continued weakening of the U.S. Dollar was an increase in general and administrative expense of $0.3 and $0.7 million for the three and six months ended June 30, 2004, as compared to the same periods in 2003, respectively. Included in general and administrative expenses for the three and six months ended June 30, 2004 were $0.1 million and $0.6 million in consulting fees in connection with our preparation of compliance with Sarbanes-Oxley Rule 404 on internal controls that is currently scheduled to become effective as of the end of 2004. We incurred no expenses related to the compliance preparation with Sarbanes-Oxley Rule 404 in the first half of 2003. Lastly, insurance premiums increased by $0.2 million and $0.3 million, comparing the three and six months ended June 30, 2004 to the same periods in 2003, respectively, due to growth in our business and general economic conditions in the insurance industry. The remaining increase in general and administrative expenses resulted from the organic growth of our business.

General and administrative expense as a percentage of net product sales was 16% and 15% for the three and six months ended June 30, 2004, respectively, compared to 13% for both the three and six months ended June 30, 2003.

**Interest Expense.** Interest expense includes interest charges, the write-off and amortization of deferred financing costs and the amortization of non-cash discounts associated with our debt issuances and the change in market value of our interest rate swap agreement which did not qualify as a hedge for accounting purposes. Interest expense increased by $2.6 million, or 137%, to $4.5 million for the three months ended June 30, 2004 from $1.9 million for the three months ended June 30, 2003. Interest expense increased by $8.0 million, or 186%, to $12.3 million for the six months ended June 30, 2004 from $4.3 million for the six months ended June 30, 2003. In the three and six months ended June 30, 2004, we recorded a charge of $0.3 million and $3.8 million, respectively, representing the write-off of deferred financing costs and prepayment fees and penalties related to the repayment of borrowings under our primary senior credit facility and certain subordinated notes with the proceeds from our $150.0 million Bond offering in February 2004. Excluding such charge, interest expense increased by $2.3 million and $4.2 million, comparing the three and six months ended June 30, 2004 to the same periods in 2003, respectively. Such increase was primarily due to a higher average outstanding debt balance which was $183.9 million during the six months ended June 30, 2004, compared to $104.7 million during the six months ended June 30, 2003, primarily as a result of the borrowings to finance the acquisitions of ABI and the product lines from Abbott in the second half of 2003. Additionally, the 8.75% interest rate on the $150.0 million Bonds increased our average interest expense to 8.5% as of June 30, 2004, compared to 6.2% as of June 30, 2003. The Bonds, which are due in 2012, provide us with a long-term fixed rate on a significant portion of our indebtedness, as compared to the variable rates under our senior credit facilities.

**Other Income, Net.** Other income, net, includes interest income, realized and unrealized foreign exchange gains and losses, and other income and expense. The components and the respective amounts of other income, net, are summarized as follows:

| | Three Months ended June 30, | | Six Months ended June 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| | (in thousands) | | | |
| Interest income | $ 225 | $ 279 | $ 572 | $ 569 |
| Foreign exchange gains and (losses), net | (185) | 438 | (151) | 498 |
| Other | (11) | 5,015 | 55 | 4,953 |
| Total other income, net | $ 29 | $ 5,732 | $ 476 | $ 6,020 |

Included in other income, net, for the three and six months ended June 30, 2003 is $1.2 million of past royalties received as part of a patent infringement settlement and a one-time gain of $3.8 million recorded in connection with an agreement with Unilever Plc (the seller of the Unipath business) which resolved certain issues that arose out of our acquisition of the Unipath business.

**Income Tax Provision.** During the three and six months ended June 30, 2004, we recorded an income tax provision of $1.8 million and $1.9 million, respectively, compared to $1.2 million and $2.4 million for the three and six months ended June 30, 2003, respectively. The 2004 provision recorded relates to foreign and state income taxes and to the recognition of a U.S. deferred tax liability related to temporary differences between the book and taxes bases of the goodwill and certain intangible assets with indefinite lives created as part of the acquisition of the Abbott business. Although we incurred a pre-tax loss in 2004, certain domestic and foreign subsidiaries realized pre-tax income. These subsidiaries recorded a tax provision based on the applicable statutory income tax rates. The effective tax rate was (33)% and (22)% for the three and six months ended June 30, 2004, respectively, compared to 18% and 25% for the three and six months ended June 30, 2003, respectively. The significant change in the effective tax rates is primarily due to our inability to benefit current losses in most tax jurisdictions.

**Net (Loss) Income.** We incurred a net loss for the three and six months ended June 30, 2004 of $7.1 million and $10.7 million, respectively, while for the three and six months ended June 30, 2003, we generated net income of $5.2 million and $7.1 million, respectively. After taking into account charges for redemption premium and amortization of a beneficial conversion feature related to our Series A redeemable convertible preferred stock, we had a net loss available to common stockholders of $7.1 million, or $0.36 per basic and diluted common share, for the three months ended June 30, 2004, compared to basic and diluted income available to common stockholders of $5.1 million and $5.2 million, or $0.36 and $0.31 per basic and diluted common share, respectively, for the three months ended June 30, 2003. We had a net loss available to common stockholders of $11.5 million, or $0.59 per basic and diluted common share, for the six months ended June 30, 2004, compared to basic and diluted income available to common stockholders of $6.8 million and $7.1 million, or $0.49 and $0.43 per basic and diluted common share, respectively, for the six months ended June 30, 2003. The loss for the three and six months ended June 30, 2004 and the income recorded in the same periods in 2003 resulted primarily from the various factors as discussed above. See note 5 of our condensed consolidated financial statements included elsewhere in this quarterly report on Form 10-Q for the calculation of earnings per share.

**Liquidity and Capital Resources**

Based upon our current working capital position, current operating plans and expected business conditions, we believe that our existing capital resources and credit facilities will be adequate to fund our operations, including our outstanding debt and other commitments, as discussed below, for the next 12 months. In the long-run, we expect to fund our working capital needs and other commitments through our operating cash flow, primarily as we expect to grow our business through new product introduction and market share through our strong intellectual property position. Our current cost savings initiatives, including our plan to move certain of our manufacturing to China and consolidate our U.S. packaging and distribution facilities, should help fund our working capital needs and commitments as well, both in the short- and long-term. We also expect to rely on our credit facilities to fund a portion of our capital needs and other commitments.

Our funding plans for our working capital needs and other commitments may be adversely impacted by unexpected costs associated with prosecuting and defending our existing lawsuits and/or unforeseen lawsuits against us, integrating the operations of ABI and the product lines acquired from Abbott Laboratories and executing our cost savings strategies. We also cannot be certain that our underlying assumed levels of revenues and expenses will be realized. In addition, we intend to continue to make significant investments in our research and development efforts related to the substantial intellectual property portfolio we own. We may also choose to further expand our research and development efforts and may pursue the acquisition of new products and technologies through licensing arrangements, business acquisitions, or otherwise. We may also choose to make significant investment to pursue legal remedies against potential infringers of our intellectual property. If we decide to engage in such activities, or if our operating results fail to meet our expectations, we could be required to seek additional funding through public or private financings or other arrangements. In such event, adequate funds may not be available when needed, or, may be available only on terms which could have a negative impact on our business and results of operations. In addition, if we raise additional funds by issuing equity or convertible securities, dilution to then existing stockholders may result.

*Changes in Cash Position*

As of June 30, 2004, we had cash and cash equivalents of $22.0 million, a $2.6 million decrease, or 11%, from December 31, 2003. Since our split-off from our former parent company and its merger transaction with Johnson & Johnson in November 2001, we have funded our business through operating cash flows, proceeds from borrowings and the issuance of equity securities. During the six months ended June 30, 2004, we generated cash of $6.0 million in our operating activities, which resulted from income, adjusted for non-cash items, of $5.4 million and a net working capital decrease, excluding the change in cash balance, of $0.6 million. Our non-equity financing activities, primarily the issuance of the Bonds in February 2004, net of repayments of borrowings under our primary senior credit facility and certain subordinated notes and bond origination costs, provided us with cash of $11.4 million during the six months ended June 30, 2004. In addition, we received $0.5 million in proceeds from the exercises of common stock options during the six months ended June 30, 2004.

During the six months ended June 30, 2004, we used cash of $20.1 million which consisted of $8.5 million paid for transaction costs associated with previously acquired businesses and the recent acquisitions of Viva Diagnostika and Advantage Diagnostics Corporation, or ADC, $9.7 million in capital expenditures, net of proceeds from sales of equipment, $0.8 million in miscellaneous scheduled debt repayments, payments of financing costs of $0.3 million and an increase in other non-current assets of $0.8 million. Fluctuations in foreign currencies negatively impacted our cash balance by $0.4 million during the six months ended June 30, 2004.

*Investing Activities*

During the six months ended June 30, 2004, we incurred $9.7 million in capital expenditures, net of proceeds from sales of equipment. We incurred capital expenditures of approximately $0.9 million for the preparation of our facilities for the manufacture of the visual version of Pfizer's e.p.t pregnancy test which we began to sell to Pfizer in June 2004, $1.3 million in connection with our pro-thrombin test, which is scheduled to launch in the first quarter of 2005, and $0.6 million for new tools related to the manufacture of a new format of our drugs of abuse test. We also continued to make significant investment in laboratory instrument systems that we placed with our customers in connection with our roll out of certain of our professional diagnostic products, which amounted to $1.7 million for the six months ended June 30, 2004. Other miscellaneous capital expenditures during the six months ended June 30, 2004 included: (i) approximately $0.5 in machinery in connection with the transition of the manufacturing of the Abbott products from Abbott, (ii) $0.9 million in computer software in connection with the implementation of the SAP system in our U.S. facilities, (iii) $0.3 million in leasehold improvements in connection with our initiative to consolidate our U.S. distribution facility. The remaining capital expenditures during the six months ended June 30, 2004 was incurred for the purchase of additional equipment to support our organic growth and various research and development activities.

On June 16, 2004, we acquired ADC, a closely held lateral flow diagnostic company that specializes in rapid test development and component manufacturing. The purchase price of ADC consisted of $2.4 million in cash and $0.2 million in assumed debt. The terms of the merger agreement also provide for $1.5 million of contingent consideration payable to the ADC shareholders upon the successful completion of a new product under development by December 31, 2005. We believe that the acquisition of ADC and the addition of ADC's chief scientist to our existing staff will deepen our scientific research management and expand our intellectual property capabilities.

On June 2, 2004, we acquired Viva, a closely held distributor of professional diagnostic products to the German marketplace. The purchase price of Viva consisted of $2.6 million in cash, 155,000 shares of our common stock with an aggregate fair value of $3.0 million and approximately $0.3 million in assumed debt. We believe that Viva, with its established German distribution network, will provide us with expanded distribution channel for our professional diagnostic products, as well as for our cardiac products in development.

*Financing Activities*

On February 10, 2004, we completed the sale of $150.0 million of 8.75% Bonds due 2012 in a private placement to qualified institutional buyers. Net proceeds from this offering amounted to $145.9 million, which was net of underwriters' commissions of $4.1 million. Of the net proceeds, we used $125.3 million to repay all of our outstanding indebtedness and related financing fees under our primary senior credit facility and $9.2 million to prepay our outstanding 9% subordinated promissory notes and related prepayment penalties, as discussed below. The remaining $11.4 million of unused proceeds is being used for Bond offering expenses and general corporate purposes. We also retained the $50.0 million in available credit under our primary senior credit facility after our repayment of the outstanding borrowings using the Bond proceeds.

The Bonds accrue interest from the date of their issuance, or February 10, 2004, at the rate of 8.75% per year. Interest on the Bonds will be payable semi-annually in arrears on each February 15 and August 15, commencing on August 15, 2004. As of June 30, 2004, accrued interest related to the Bonds amounted to $5.1 million. We may redeem the Bonds, in whole or in part, at any time on or after February 15, 2008, at a redemption price equal to 100% of the principal amount plus a premium declining ratably to par, plus accrued and unpaid interest. In addition, prior to February 15, 2007, we may redeem up to 35% of the aggregate principal amount of the Bonds issued with the proceeds of qualified equity offerings at a redemption price equal to 108.75% of the principal amount, plus accrued

and unpaid interest. If we experience a change of control, we may be required to offer to purchase the Bonds at a purchase price equal to 101% of the principal amount, plus accrued and unpaid interest. We might not be able to pay the required price for Bonds presented to us at the time of a change of control because our primary senior credit facility or other indebtedness may prohibit payment or we might not have enough funds at that time.

The Bonds are unsecured and are subordinated in right of payment to all of our existing and future senior debt, including our guarantee of all borrowings under our primary senior credit facility. The Bonds are effectively subordinated to all existing and future liabilities, including trade payables, of those of our subsidiaries that do not guarantee the Bonds.

The Bonds are guaranteed by all of our domestic subsidiaries that are guarantors or borrowers under our primary senior credit facility, which excludes our subsidiary Inverness Medical Nutritionals Group, or IMN, in New Jersey. The guarantees are general unsecured obligations of the guarantors and are subordinated in right of payment to all existing and future senior debt of the applicable guarantors, which includes their guarantees of, and borrowings under our primary senior credit facility.

The indenture governing the Bonds contains covenants that will limit our ability and the ability of our subsidiaries to, among other things, incur additional indebtedness in the aggregate, subject to our interest coverage ratio, pay dividends or make other distributions or repurchase or redeem our stock, make investments, sell assets, incur liens, enter into agreements restricting our subsidiaries' ability to pay dividends, enter into transactions with affiliates and consolidate, merge or sell all or substantially all of our assets. These covenants are subject to certain exceptions and qualifications.

Our primary senior credit facility with a group of banks, as amended, currently provides us with revolving lines of credit in the aggregate amount of up to $50.0 million, subject to continuing covenant compliance. Prior to the repayment of all borrowings under this senior credit facility using the proceeds from our Bond offering in February 2004, as discussed above, we had obtained term loans aggregating $84.9 million and drawn upon the revolving lines of credit in the aggregate amount of $39.9 million. At June 30, 2004, we had no borrowings outstanding under the revolving lines of credit. However, we intend to refinance the outstanding borrowings under IMN's senior credit facility, as discussed below, using a portion of our primary revolving lines of credit during the second half of 2004.

We may repay any future borrowings under the revolving lines of credit at any time but in no event later than March 31, 2008. We are required to make mandatory prepayments under our primary senior credit facility if we meet certain cash flow thresholds, issue equity securities or subordinated debt, or sell assets not in the ordinary course of our business.

Borrowings under the revolving lines of credit bear interest at either (1) the London Interbank Offered Rate, or LIBOR, as defined in the credit agreement, plus applicable margins or, at our option, (2) a floating Index Rate, as defined in the credit agreement, plus applicable margins. Applicable margins if we choose to use the LIBOR or the Index Rate can range from 2.75% to 3.75% or 1.50% to 2.50%, respectively, depending on the quarterly adjustments that are based on our consolidated financial performance, excluding IMN's. As of June 30, 2004, the applicable interest rate under the revolving lines of credit, including the applicable margin, had there been borrowings outstanding would have been 5.12%.

Borrowings under our primary senior credit facility are secured by the stock of our U.S. and European subsidiaries, substantially all of our intellectual property rights and the assets of our businesses in the U.S. and Europe, excluding those assets of IMN, Orgenics Ltd., our Israeli subsidiary, and Unipath Scandinavia AB, our Swedish subsidiary, and the stock of IMN, Orgenics and certain smaller subsidiaries. Under the senior credit agreement, as amended, we must comply with various financial and non-financial covenants. The primary financial covenants pertain to, among other things, fixed charge coverage ratio, capital expenditures, various leverage ratios, EBITDA, and a minimum

cash requirement. Additionally, the senior credit agreement currently prohibits us from paying dividends. We are currently in compliance with the covenants, as amended.

On September 20, 2002, we sold units having an aggregate purchase price of $20.0 million to private investors to help finance our acquisition of Wampole. Each unit was issued for $50,000 and consisted of (1) a 10% subordinated promissory note in the principal amount of $50,000 and (2) a warrant to acquire 400 shares of our common stock at an exercise price of $13.54 per share. In the aggregate, we issued fully vested warrants to purchase 160,000 shares of our common stock, which may be exercised at any time on or prior to September 20, 2012. In addition, the placement agent for the offering of the units received a warrant to purchase 37,700 shares of our common stock, the terms of which are identical to the warrants sold as a part of the units. The 10% subordinated notes accrue interest on the outstanding principal amount at 10% per annum, which is payable quarterly in arrears on the first day of each calendar quarter starting October 1, 2002. The 10% subordinated notes mature on September 20, 2008, subject to acceleration in certain circumstances, and we may prepay the 10% subordinated notes at any time, subject to certain prepayment penalties and the consent of our senior lenders. Prepayments are made in cash or in shares of our common stock valued at 95% of the average closing price of such stock over the ten consecutive trading days immediately preceding the payment date. The 10% subordinated notes are expressly subordinated to up to $150.0 million of indebtedness for borrowed money incurred or guaranteed by our company plus any other indebtedness that we incur to finance or refinance an acquisition. Among the purchasers of the units were three of our directors and officers and an entity controlled by our chief executive officer, who collectively purchased an aggregate of 37 units consisting of 10% subordinated notes in the aggregate principal amount of $1.85 million and warrants to purchase an aggregate of 14,800 shares of our common stock.

On September 20, 2002, also in connection with the financing of the Wampole acquisition, we sold 9% subordinated promissory notes in an aggregate principal amount of $9.0 million and 3% subordinated convertible promissory notes in an aggregate principal amount of $6.0 million to private investors for an aggregate purchase price of $15.0 million. The 9% subordinated notes and 3% convertible notes accrue interest on the outstanding principal amount at 9% and 3% per annum, respectively, which is payable quarterly in arrears on the first day of each calendar quarter starting October 1, 2002.

In February 2004, we prepaid the outstanding balance of the 9% subordinated notes, or $9.0 million, and a consequential prepayment penalty of $180,000 with the proceeds from the Bond issuance, as discussed above.

The 3% subordinated notes mature on September 20, 2008, subject to acceleration in certain circumstances. If we repay the 3% convertible notes, we may do so in cash or in shares of our common stock valued at 95% of the average closing price of such stock over the ten consecutive trading days immediately preceding the payment date. At any time prior to the maturity date, the holders of the 3% convertible notes have the option to convert all of their outstanding principal amounts and unpaid interest into shares of our common stock at a conversion price equal to $17.45. Additionally, the outstanding principal amount and unpaid interest on the 3% convertible notes will automatically convert into common stock at a conversion price equal to $17.45 if, at any time after September 20, 2004, the average closing price of our common stock in any consecutive thirty day period is greater than $22.67. An entity controlled by our chief executive officer purchased 3% convertible notes in the aggregate principal amount of $3.0 million.

As of June 30, 2004, our subsidiary IMN had a total outstanding debt balance of $16.3 million, of which $12.8 million represented borrowings under a credit agreement with its senior lender and $3.5 million related to various notes payable and capital leases. Under the credit agreement with its senior lender, as amended, IMN can borrow up to $15.0 million under a revolving credit commitment and $4.2 million under a term loan commitment, subject to specified borrowing base limitations. Borrowings under the revolving credit commitment and the term loan bear interest at either 1.50%

above the bank's prime rate or, at IMN's option, at 3.75% above the Adjusted Eurodollar Rate used by the bank. As of June 30, 2004, the interest rates on the loans with its senior lender ranged from 5.31% to 5.50%. The notes are collateralized by substantially all of IMN's assets. The credit agreement with its senior lender requires IMN to maintain minimum tangible net worth and contains various restrictions customary in such financial arrangements, including limitations on the payment of cash dividends. As of June 30, 2004, IMN was in compliance with such requirements and restrictions. The loans with IMN's senior lender were set to mature on October 15, 2004, but subsequent to June 30, 2004 the maturity date was automatically extended to October 17, 2005. However, we expect to refinance the loans with IMN's senior lender using our primary revolving lines of credit, as discussed above, during the second half of 2004. IMN's other notes payable and capital leases mature on various dates through July 2008.

In January 2004, all of our then outstanding Series A redeemable convertible preferred stock, or 208,060 shares, were converted at our option into 416,120 shares of our common stock.

*Income Taxes*

As of December 31, 2003, we had approximately $73.8 million and $20.6 million of domestic and foreign net operating loss carryforwards, respectively, which either expire on various dates through 2023 or can be carried forward indefinitely. These losses are available to reduce federal and foreign taxable income, if any, in future years. These losses are also subject to review and possible adjustments by the applicable taxing authorities and may be limited in the event of certain cumulative changes in ownership interests of significant shareholders over a three-year period in excess of 50%. In addition, the domestic operating loss carryforward amount at December 31, 2003 included approximately $48.1 million of pre-acquisition losses at IMN and Ostex. These pre-acquisition losses are subject to the IRS Code Section 382 limitation. Section 382 imposes an annual limitation on the use of these losses to an amount equal to the value of the acquired company multiplied by the long term tax exempt rate. We have recorded a valuation allowance against a portion of the deferred tax assets related to our net operating losses and certain of our other deferred tax assets to reflect uncertainties that might affect the realization of such deferred tax assets, as these assets can only be realized via profitable operations.

**Off-Balance Sheet Arrangements**

We had no material off-balance sheet arrangements as of June 30, 2004.

**Contractual Obligations**

The following table summarizes our principal contractual obligations as of June 30, 2004 that have changed significantly since December 31, 2003 and the effects such obligations are expected to have on our liquidity and cash flow in future periods. Contractual obligations that were presented in our annual report on Form 10-K/A for the year ended December 31, 2003 but omitted in the table below represent those that have not changed significantly since December 31, 2003.

| | Payments Due by Period | | | | |
|---|---|---|---|---|---|
| **Contractual Obligations** | **Total** | **Remainder of 2004** | **2005-2006** | **2007-2008** | **Thereafter** |
| | | | **(in thousands)** | | |
| Long-term debt obligations(1) | $ 190,373 | $ 1,050 | $ 13,223 | $ 26,100 | $ 150,000 |
| Purchase obligations capital expenditure(2) | 7,038 | 7,038 | | | |
| Purchase obligations other(3) | 31,164 | 31,164 | | | |

(1) The total amount and scheduled payments of long-term debt obligations changed significantly since December 31, 2003 as a result of the $150.0 million Bond issuance in February 2004 and the recent automatic one-year extension of maturity date of IMN's senior loans.

(2)

Purchase obligations of capital expenditure increased by $5.0 million, as compared to the commitments at December 31, 2003. See discussion related to capital expenditure in the above section titled "Liquidity and Capital Resources  Investing Activities."

(3)

Other purchase obligations relate to inventory purchases and other operating expense commitments. Other purchase obligations increased by $17.6 million, as compared to the commitments at December 31, 2003, which primarily resulted from increased inventory purchase commitments in anticipation of sales increases in the remainder of 2004 and the manufacturing transition of certain of the acquired Abbott products to our facilities.

**Critical Accounting Policies**

The consolidated financial statements included elsewhere in this quarterly report on Form 10-Q are prepared in accordance with GAAP. The accounting policies discussed below are considered by our management and our audit committee to be critical to an understanding of our financial statements because their application depends on management's judgment, with financial reporting results relying on estimates and assumptions about the effect of matters that are inherently uncertain. Specific risks for these critical accounting policies are described in the following paragraphs. For all of these policies, management cautions that future events rarely develop exactly as forecast and the best estimates routinely require adjustment. In addition, the notes to our audited consolidated financial statements for the year ended December 31, 2003 included in our annual report on Form 10-K/A filed on February 11, 2005, include a comprehensive summary of the significant accounting policies and methods used in the preparation of our consolidated financial statements.

*Revenue Recognition*

We primarily recognize revenue when the following four basic criteria have been met: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the fee is fixed and determinable; and (4) collection is reasonably assured.

The majority of our revenues are derived from product sales. We do not enter into arrangements with multiple element deliverables. We recognize revenue upon title transfer of the products to third-party customers, less a reserve for estimated product returns and allowances. Determination of the reserve for estimated product returns and allowances is based on our management's analyses and judgments regarding certain conditions, as discussed below in the critical accounting policy "Use of Estimates for Sales Returns and Other Allowances and Allowance for Doubtful Accounts." Should future changes in conditions prove management's conclusions and judgments on previous analyses to be incorrect, revenue recognized for any reporting period could be adversely affected.

In connection with the acquisition of the rapid diagnostics business from Abbott in September 2003, we entered into a transition services agreement with Abbott, whereby Abbott would continue to distribute the acquired products sold under the TestPack brand for a period of up to 18 months. During the transition period, we recognize revenue on sales of the TestPack products when title transfers from Abbott to third-party customers.

We also receive license and royalty revenue from agreements with third-party licensees. Revenue from fixed fee license and royalty agreements are recognized on a straight-line basis over the obligation period of the related license agreements. License and royalty fees that the licensees calculate based on their sales, which we have the right to audit under most of our agreements, are generally recognized upon receipt of the license or royalty payments unless we are able to reasonably estimate the fees as they are earned. License and royalty fees that are determinable prior to the receipt thereof are recognized in the period they are earned.

*Use of Estimates for Sales Returns and Other Allowances and Allowance for Doubtful Accounts*

Sales arrangements with customers for our consumer products generally require us to accept product returns. From time to time, we also enter into sales incentive arrangements with our retail customers, which generally reduce the sale prices of our products. As a result, we must establish allowances for potential future product returns and claims resulting from our sales incentive arrangements against product revenue recognized in any reporting period. Calculation of these allowances requires significant judgments and estimates. When evaluating the adequacy of the sales returns and other allowances, our management analyzes historical returns, current economic trends, and changes in customer and consumer demand and acceptance of our products. Material differences in the amount and timing of our product revenue for any reporting period may result if changes in conditions arise that would require management to make different judgments or utilize different estimates.

Our total provision for sales returns and other allowances related to sales incentive arrangements amounted to approximately $13.2 million and $26.6 million for the three and six months ended June 30, 2004, respectively, compared to $10.8 million and $20.9 million for the three and six months ended June 30, 2003, respectively, which have been recorded against product sales to derive our net product sales.

Similarly, our management must make estimates regarding uncollectible accounts receivable balances. When evaluating the adequacy of the allowance for doubtful accounts, management analyzes specific accounts receivable balances, historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms and patterns. Our accounts receivable balance was $53.4 million and $55.4 million, net of allowances for doubtful accounts of $2.4 million and $0.8 million, as of June 30, 2004 and December 31, 2003, respectively. The significant increase in the allowance for doubtful accounts from December 31, 2003 to June 30, 2004 primarily resulted from the establishment of a specific reserve for a doubtful accounts receivable balance of $1.4 million associated with a private label customer that failed to perform under the terms of our agreement during the second quarter of 2004 and is now the subject of legal action commenced in July 2004.

*Valuation of Inventories*

We state our inventories at the lower of the actual cost to purchase or manufacture the inventory or the estimated current market value of the inventory. In addition, we periodically review the inventory quantities on hand and record a provision for excess and obsolete inventory. This provision reduces the carrying value of our inventory and is calculated based primarily upon factors such as forecasts of our customers' demands, shelf lives of our products in inventory, loss of customers and manufacturing lead times. Evaluating these factors, particularly forecasting our customers' demands, requires management to make assumptions and estimates. Actual product sales may prove our forecasts to be inaccurate, in which case we may have underestimated or overestimated the provision required for excess and obsolete inventory. If, in future periods, our inventory is determined to be overvalued, we would be required to recognize the excess value as a charge to our cost of sales at the time of such determination. Likewise, if, in future periods, our inventory is determined to be undervalued, we would have over-reported our cost of sales, or understated our earnings, at the time we recorded the excess and obsolete provision. Our inventory balance was $55.1 million and $47.0 million, net of a provision for excess and obsolete inventory of $3.1 million and $2.1 million, as of June 30, 2004 and December 31, 2003, respectively.

*Valuation of Goodwill and Other Long-Lived and Intangible Assets*

Our long-lived assets include (1) property, plant and equipment, (2) goodwill and (3) other intangible assets. As of June 30, 2004, the balances of property, plant and equipment, goodwill and

other intangible assets, net of accumulated depreciation and amortization, were $61.0 million, $222.5 million and $116.7 million, respectively.

Goodwill and other intangible assets are initially created as a result of business combinations or acquisitions of intellectual property. The values we record for goodwill and other intangible assets represent fair values calculated by independent third-party appraisers. Such valuations require us to provide significant estimates and assumptions which are derived from information obtained from the management of the acquired businesses and our business plans for the acquired businesses or intellectual property. Critical estimates and assumptions used in the initial valuation of goodwill and other intangible assets include, but are not limited to: (i) future expected cash flows from product sales, customer contracts and acquired developed technologies and patents, (ii) expected costs to complete any in-process research and development projects and commercialize viable products and estimated cash flows from sales of such products, (iii) the acquired companies' brand awareness and market position, (iv) assumptions about the period of time over which we will continue to use the acquired brand, and (v) discount rates. These estimates and assumptions may be incomplete or inaccurate because unanticipated events and circumstances may occur. If estimates and assumptions used to initially value goodwill and intangible assets prove to be inaccurate, ongoing reviews of the carrying values of such goodwill and intangible assets, as discussed below, may indicate impairment which will require us to record an impairment charge in the period in which we identify the impairment.

Where we believe that property, plant and equipment and intangible assets have finite lives, we depreciate and amortize those assets over their estimated useful lives. For purposes of determining whether there are any impairment losses, as further discussed below, our management has historically examined the carrying value of our identifiable long-lived tangible and intangible assets and goodwill, including their useful lives where we believe such assets have finite lives, when indicators of impairment are present. In addition, SFAS No. 142 requires that impairment reviews be performed on the carrying values of all goodwill on at least an annual basis. For all long-lived tangible and intangible assets and goodwill, if an impairment loss is identified based on the fair value of the asset, as compared to the carrying value of the asset, such loss would be charged to expense in the period we identify the impairment. Furthermore, if our review of the carrying values of the long-lived tangible and intangible assets with finite lives indicates impairment of such assets, we may determine that shorter estimated useful lives are more appropriate. In that event, we will be required to record additional depreciation and amortization in future periods, which will reduce our earnings.

Valuation of Goodwill

We have goodwill balances related to our consumer diagnostics and professional diagnostics reporting units, which amounted to $86.7 million and $135.8 million, respectively, as of June 30, 2004. As of December 31, 2003, we performed our annual impairment review on the carrying values of such goodwill using the discounted cash flows approach. Based upon this review, we do not believe that the goodwill related to our consumer diagnostics and professional diagnostics reporting units were impaired. Because future cash flows and operating results used in the impairment review are based on management's projections and assumptions, future events can cause such projections to differ from those used at December 31, 2003, which could lead to significant impairment charges of goodwill in the future. No events or circumstances have occurred since our review as of December 31, 2003, that would require us to reassess whether the carrying values of our goodwill have been impaired.

Valuation of Other Long-Lived Tangible and Intangible Assets

Factors we generally consider important which could trigger an impairment review on the carrying value of other long-lived tangible and intangible assets include the following: (1) significant underperformance relative to expected historical or projected future operating results; (2) significant changes in the manner of our use of acquired assets or the strategy for our overall business; (3) underutilization of our tangible assets; (4) discontinuance of product lines by ourselves or our

customers; (5) significant negative industry or economic trends; (6) significant decline in our stock price for a sustained period; (7) significant decline in our market capitalization relative to net book value; and (8) goodwill impairment identified during an impairment review under SFAS No. 142. Although we believe that the carrying value of our long-lived tangible and intangible assets was realizable as of June 30, 2004, future events could cause us to conclude otherwise.

*Accounting for Income Taxes*

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us estimating our actual current tax exposure and assessing temporary differences resulting from differing treatment of items, such as reserves and accruals and lives assigned to long-lived and intangible assets, for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that our deferred tax assets will be recovered through future taxable income and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within our tax provision.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We have recorded a valuation allowance of $69.4 million as of December 31, 2003 due to uncertainties related to the future benefits, if any, from our deferred tax assets related primarily to our U.S. businesses and certain foreign net operating losses and tax credits. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to establish an additional valuation allowance or reduce our current valuation allowance which could materially impact our tax provision.

*Legal Contingencies*

In the section of our annual report on Form 10-K/A for the year ended December 31, 2003 titled "Item 3. Legal Proceedings" and the section of this quarterly report on Form 10-Q titled "Part II. Item 1. Legal Proceedings," we have reported on certain material pending legal proceedings. In addition, because of the nature of our business, we may from time to time be subject to commercial disputes, consumer product claims or various other lawsuits arising in the ordinary course of our business, and we expect this will continue to be the case in the future. These lawsuits generally seek damages, sometimes in substantial amounts, for commercial or personal injuries allegedly suffered and can include claims for punitive or other special damages. In addition, we aggressively defend our patent and other intellectual property rights. This often involves bringing infringement or other commercial claims against third parties, which can be expensive and can result in counterclaims against us.

We do not accrue for potential losses on legal proceedings where our company is the defendant when we are not able to reasonably estimate our potential liability, if any, due to uncertainty as to the nature, extent and validity of the claims against us, uncertainty as to the nature and extent of the damages or other relief sought by the plaintiff and the complexity of the issues involved. Our potential liability, if any, in a particular case may become reasonably estimatable and probable as the case progresses, in which case we will begin accruing for the expected loss.

**Certain Factors Affecting Future Results**

The risk factors described below may materially impact your investment in our company or may in the future, and, in some cases already do, materially affect us and our business, financial condition and results of operations. You should carefully consider these factors with respect to your investment in our securities. This section includes or refers to certain forward-looking statements; you should read the explanation of the qualifications and limitations on such forward-looking statements beginning on pages 2, 28 and 61 of this report.

**Our business has substantial indebtedness, which could, among other things, make it more difficult for us to satisfy our debt obligations, require us to use a large portion of our cash flow from operations to repay and service our debt or otherwise create liquidity problems, limit our flexibility to adjust to market conditions, place us at a competitive disadvantage and expose us to interest rate fluctuations.**

We currently have, and we will likely continue to have, a substantial amount of indebtedness. As of June 30, 2004, we had approximately $192.8 million in aggregate principal indebtedness outstanding, of which $16.8 million is secured indebtedness, and $50.4 million of additional borrowing capacity under the revolving portions of our credit facilities. In addition, subject to restrictions in our credit facilities and the indenture governing the senior subordinated notes, we may incur additional indebtedness. During the year ended December 31, 2003 and the six months ended June 30, 2004, we recorded $9.7 million and $12.3 million, respectively, of interest expense related to our indebtedness, which included $1.0 million and $3.5 million, respectively, in non-cash interest primarily related to amortization of debt origination costs.

Our substantial indebtedness could affect our future operations in important ways. For example, it could:

make it more difficult to satisfy our obligations under the senior subordinated notes, our credit facilities and our other debt-related instruments;

require us to use a large portion of our cash flow from operations to pay principal and interest on our indebtedness, which would reduce the amount of cash available to finance our operations and other business activities and may require us, in order to meet our debt service obligations, to delay or reduce capital expenditures or the introduction of new products and/or forego business opportunities, including acquisitions, research and development projects or product design enhancements;

limit our flexibility to adjust to market conditions, leaving us vulnerable in a downturn in general economic conditions or in our business and less able to plan for, or react to, changes in our business and the industries in which we operate;

impair our ability to obtain additional financing;

place us at a competitive disadvantage compared to our competitors that have less debt; and

expose us to fluctuations in the interest rate environment with respect to our indebtedness that bears interest at variable rates.

We expect to obtain the money to pay our expenses and to pay the principal and interest on the senior subordinated notes, our senior credit facility and our other debt from cash flow from our operations and from additional loans under our senior credit facility, subject to continued covenant compliance. Our ability to meet our expenses thus depends on our future performance, which will be affected by financial, business, economic and other factors. We will not be able to control many of these factors, such as economic conditions in the markets in which we operate and pressure from competitors. We cannot be certain that our cash flow will be sufficient to allow us to pay principal and interest on our debt and meet our other obligations. If our cash flow and capital resources prove

inadequate, we could face substantial liquidity problems and might be required to dispose of material assets or operations, restructure or refinance our debt, including the notes, seek additional equity capital or borrow more money. We cannot guarantee that we will be able to do so on terms acceptable to us. In addition, the terms of existing or future debt agreements, including the credit agreement governing our senior credit facility and the indenture governing the senior subordinated notes, may restrict us from adopting any of these alternatives.

**We have entered into agreements governing our indebtedness that subject us to various restrictions that may limit our ability to pursue business opportunities.**

The agreements governing our indebtedness, including the credit agreement governing our senior credit facility and the indenture governing the senior subordinated notes, subject us to various restrictions on our ability to engage in certain activities, including, among other things, our ability to:

incur additional indebtedness;

pay dividends or make distributions or repurchase or redeem our stock;

acquire other businesses;

make investments;

make loans to or extend credit for the benefit of third parties or our subsidiaries;

enter into transactions with affiliates;

raise additional capital;

make capital or finance lease expenditures;

dispose of or encumber assets; and

consolidate, merge or sell all or substantially all of our assets.

These restrictions may limit our ability to pursue business opportunities or strategies that we would otherwise consider to be in our best interests. In particular, all acquisitions of other businesses, other than very small acquisitions, will require us to obtain our lenders' consent under our senior credit facility. We have been required to obtain, and have obtained, our lenders' consent under our senior credit facility in order to complete our acquisitions of the Wampole Division of MedPointe Inc., or Wampole, Ostex International, Inc., or Ostex, ABI, and the assets related to the rapid diagnostics product lines that we acquired from Abbott Laboratories, or the Abbott rapid diagnostics product lines.

**Our credit facilities contain certain financial covenants that we may not satisfy which, if not satisfied, could result in the acceleration of the amounts due under our credit facilities and the limitation of our ability to borrow additional funds in the future.**

As of June 30, 2004, we had approximately $12.9 million of indebtedness outstanding under our various credit facilities and approximately $50.4 million of additional borrowing capacity under these credit facilities. The agreements governing these credit facilities subject us to various financial and other covenants with which we must comply on an ongoing or periodic basis. These include covenants pertaining to fixed charge coverage, capital expenditures, various leverage ratios, minimum EBITDA, total net worth and minimum cash requirements. If we violate any of these covenants, there may be a material adverse effect on us. Most notably, our outstanding debt under one or more of our credit facilities could become immediately due and payable, our lenders could proceed against any collateral securing such indebtedness, and our ability to borrow additional funds in the future may be limited.

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**A default under any of our agreements governing our indebtedness could result in a default and acceleration of indebtedness under other agreements.**

The agreements governing our indebtedness, including our senior credit facility and the indenture governing the senior subordinated notes, contain cross-default provisions whereby a default under one agreement could result in a default and acceleration of our repayment obligations under other agreements. If a cross-default were to occur, we may not be able to pay our debts or borrow sufficient funds to refinance them. Even if new financing were available, it may not be on commercially reasonable terms or terms that are acceptable to us. If some or all of our indebtedness is in default for any reason, our business, financial condition and results of operations could be materially and adversely affected.

**We may not be able to satisfy our debt obligations upon a change of control, which could limit our opportunity to enter into a change of control transaction.**

Upon the occurrence of a "change of control," as defined in the indenture governing the senior subordinated notes, each holder of our senior subordinated notes will have the right to require us to purchase the notes at a price equal to 101% of the principal amount, together with any accrued and unpaid interest. Our failure to purchase, or give notice of purchase of, the senior subordinated notes would be a default under the indenture, which would in turn be a default under our senior credit facility. In addition, a change of control may constitute an event of default under our senior credit facility. A default under our senior credit facility would result in an event of default under our 3% convertible notes, 10% subordinated notes and, if the lenders accelerate the debt under our senior credit facility, the indenture, and may result in the acceleration of any of our other indebtedness outstanding at the time. As a result, if we do not have enough cash to repay all of our indebtedness or to repurchase all of the senior subordinated notes, we may be limited in the change of control transactions that we may pursue.

**Our acquisitions, and in particular our acquisitions of ABI and the Abbott rapid diagnostics product lines, may not be profitable, and the integration of these businesses or product lines may be costly and difficult and may cause disruption of our business.**

Since we commenced activities in November 2001, we have acquired and attempted to integrate into our operations Unipath Limited and its associated companies and assets, or the Unipath business, IVC Industries, Inc. (now doing business as Inverness Medical Nutritionals Group, or IMN), Wampole, and Ostex. On August 27, 2003, we acquired ABI, and on September 30, 2003, we acquired the Abbott rapid diagnostics product lines. We have also made smaller acquisitions such as our recent acquisitions of Viva Diagnostika and Advantage Diagnostics Corporation. The ultimate success of all of our acquisitions depends, in part, on our ability to realize the anticipated synergies, cost savings and growth opportunities from integrating these businesses or product lines into our existing businesses. However, the successful integration of independent companies or product lines is a complex, costly and time-consuming process. The difficulties of integrating companies and acquired assets include among others:

- consolidating manufacturing and research and development operations, where appropriate;
- integrating newly acquired businesses or product lines into a uniform financial reporting system;
- coordinating sales, distribution and marketing functions;
- establishing or expanding manufacturing, sales, distribution and marketing functions in order to accommodate newly acquired businesses or product lines;
- preserving the important licensing, research and development, manufacturing and supply, distribution, marketing, customer and other relationships;

minimizing the diversion of management's attention from ongoing business concerns; and

coordinating geographically separate organizations.

We may not accomplish the integration of our acquisitions smoothly or successfully. The diversion of the attention of our management from our current operations to the integration effort and any difficulties encountered in combining operations could prevent us from realizing the full benefits anticipated to result from these acquisitions and adversely affect our other businesses. Additionally, unexpected costs associated with the integration of our acquisitions, including the integration of the operations of Ostex and ABI and the product lines acquired from Abbott Laboratories, could adversely impact our liquidity. Ultimately, the value of any company, product line or assets that we have acquired may not be greater than or equal to their purchase prices.

**If we choose to acquire or invest in new and complementary businesses, products or technologies instead of developing them ourselves, such acquisitions or investments could disrupt our business and, depending on how we finance these acquisitions or investments, could result in the use of significant amounts of cash.**

Our success depends in part on our ability to continually enhance and broaden our product offerings in response to changing technologies, customer demands and competitive pressures. Accordingly, from time to time we may seek to acquire or invest in businesses, products or technologies instead of developing them ourselves. Acquisitions and investments involve numerous risks, including:

the inability to complete the acquisition or investment;

disruption of our ongoing businesses and diversion of management attention;

difficulties in integrating the acquired entities, products or technologies;

difficulties in operating the acquired business profitably;

the inability to achieve anticipated synergies, cost savings or growth opportunities;

potential loss of key employees, particularly those of the acquired business;

difficulties in transitioning key customer, distributor and supplier relationships;

risks associated with entering markets in which we have no or limited prior experience; and

unanticipated costs.

In addition, any future acquisitions or investments may result in:

issuances of dilutive equity securities, which may be sold at a discount to market price;

use of significant amounts of cash;

the incurrence of debt;

the assumption of significant liabilities;

unfavorable financing terms;

large one-time expenses; and

the creation of certain intangible assets, including goodwill, the write-down of which may result in significant charges to earnings.

Any of these factors could materially harm our business or our operating results.

**If goodwill and/or other intangible assets that we have recorded in connection with our acquisitions of other businesses become impaired, we could have to take significant charges against earnings.**

In connection with the accounting for our acquisitions of the Unipath business, Wampole, Ostex, ABI and the Abbott rapid diagnostics product lines, we have recorded a significant amount of goodwill and other intangible assets. Under current accounting guidelines, we must assess, at least annually and potentially more frequently, whether the value of goodwill and other intangible assets has been impaired. Any reduction or impairment of the value of goodwill or other intangible assets will result in a charge against earnings which could materially adversely affect our reported results of operations in future periods.

**We could experience significant manufacturing delays, disruptions to our ongoing research and development and increased production costs if Unilever is unable to successfully assign or sublease to us the lease for the multi-purpose facility that we currently use in Bedford, England.**

One of our primary operating facilities is located in Bedford, England. The Bedford facility is a multi-purpose facility that is registered with the FDA, contains state-of-the-art research laboratories and is equipped with specialized manufacturing equipment. This facility currently provides the manufacturing for our Clearblue and Clearview products, serves as our primary research and development center and serves as the administrative center for our European operations. We also use this facility to manufacture the digital and non-digital e.p.t pregnancy tests for Pfizer in connection with our supply arrangements with Pfizer for these products. We are currently using the Bedford facility pursuant to our acquisition agreement with Unilever relating to our acquisition of the Unipath business in late 2001. Unilever currently leases this facility from a third party landlord. Pursuant to the terms of Unilever's lease, Unilever cannot assign the lease or sublet the Bedford facility to us without first obtaining the landlord's consent. The landlord has not yet, and may not in the future, consent to an assignment of the lease or a sublease to us. The terms of our acquisition agreement obligate Unilever to provide to us the benefit of its lease of the Bedford facility. If Unilever is unable to successfully acquire such consent or otherwise enable us to realize the benefit of Unilever's lease of the Bedford facility, or if its lease is terminated, we may be forced to renegotiate a lease of the Bedford facility on substantially less favorable terms or seek alternative means of producing our products, conducting our research and housing our European administrative staff. In either case, we may experience increased production costs or manufacturing delays, which could prevent us from meeting contractual supply obligations or jeopardize important customer relationships. We may also suffer disruptions to our ongoing research and development while we are resolving these issues. We cannot assure you that we will be able to renegotiate a lease for the Bedford facility on terms that are acceptable to us or find an acceptable replacement for this facility. Any one or more of these events may have a material adverse effect on us.

**We may experience manufacturing problems or delays, which could result in decreased revenues or increased costs.**

We currently produce most of our consumer products in our manufacturing facilities located in New Jersey, San Diego, Bedford, England and Galway, Ireland and some of our professional diagnostic tests in our manufacturing facilities located in Bedford, England, San Diego and Yavne, Israel. Our production processes are complex and require specialized and expensive equipment. Replacement parts for our specialized equipment can be expensive and, in some cases, can require lead times of up to a year to acquire. In addition, our private label consumer products business, and our private label and bulk nutritional supplements business in particular, rely on operational efficiency to mass produce products at low margins per unit. We also rely on third parties to supply production materials and in some cases there may not be alternative sources immediately available.

In addition, we rely on third parties to manufacture most of our professional diagnostic products and certain components of our consumer diagnostic products, including products in development. For example, certain of the Abbott rapid diagnostics product lines are currently manufactured for us by Abbott Laboratories in Chicago under the terms of a transitional arrangement. Any event impacting our manufacturing facilities, our manufacturing systems or equipment, or our contract manufacturers or suppliers, including, without limitation, wars, terrorist activities, natural disasters and outbreaks of infectious disease (such as SARS), could delay or suspend shipments of products or the release of new products or could result in the delivery of inferior products. Our revenues from the affected products would decline or we could incur losses until such time as we were able to restore our production processes or put in place alternative contract manufacturers or suppliers. Even though we carry business interruption insurance policies, we may suffer losses as a result of business interruptions that exceed the coverage available under our insurance policies.

**Sales of our new digital pregnancy test may dilute sales of our other consumer pregnancy test products or the non-digital e.p.t pregnancy test, which we manufacture for Pfizer, and, accordingly, these sales may not increase our overall revenues or profitability.**

In the second quarter of 2003, we shipped the first orders for our new digital pregnancy test, Clearblue Easy Digital, which is the first consumer pregnancy test on the market to display test results in words. We also entered into a supply agreement with Pfizer pursuant to which we began in December 2003 supplying Pfizer with a digital version of its e.p.t pregnancy tests on a non-exclusive basis. Instead of interpreting colored lines for a result, the digital display will spell out "Pregnant" or "Not Pregnant." We cannot assure you that sales of these new products will not dilute sales of our other consumer pregnancy test products or the non-digital e.p.t pregnancy test, which we will manufacture for Pfizer for a period of five years beginning in June 2004. Accordingly, there is no assurance that these new products will increase our overall revenues or profitability.

**We may experience difficulties that may delay or prevent our development, introduction or marketing of new or enhanced products.**

We intend to continue to invest in product and technology development. The development of new or enhanced products is a complex and uncertain process. We may experience research and development, manufacturing, marketing and other difficulties that could delay or prevent our development, introduction or marketing of new products or enhancements. We cannot be certain that:

- any of the products under development will prove to be effective in clinical trials;
- we will be able to obtain, in a timely manner or at all, regulatory approval to market any of our products that are in development or contemplated;
- any of such products can be manufactured at acceptable cost and with appropriate quality; or
- any such products, if and when approved, can be successfully marketed.

While we currently expect to submit a pro-thrombin test for FDA approval in late 2004 and to launch a congestive heart failure product in 2005 and new infectious disease products (including a high sensitivity strep throat test, which we recently launched, and rapid influenza A & B tests and a rapid HIV test) in 2004, the factors listed above, as well as manufacturing or distribution problems, or other factors beyond our control, could delay these launches. In addition, we cannot assure you that the market will accept these products. Accordingly, there is no assurance that our overall revenues will increase if and when these new products are launched.

**We may experience difficulties that may delay or prevent us from completing our plans to centralize our U.S. consumer products packaging and distribution facilities, and our plans to manufacture certain products in China.**

We have announced that we intend to develop a centralized U.S. consumer products packaging and distribution facility which is scheduled to be operational in the third quarter of 2004, and that we intend to transition the manufacture of portions of certain products to China beginning in the third quarter of 2004. We may not commence these operations in the time projected, or at all, if we are unable to develop or finalize the necessary third party relationships; acquire the required facilities, equipment or materials; or obtain any necessary consents or approvals. In addition, even if we do succeed in developing these new operations on schedule, operational problems, or other factors beyond our control, may prevent or delay us from recognizing cost savings, margin improvements or other benefits that we may expect, reduce product quality and harm our reputation or credibility with our customers and users of our products.

**If we fail to meet strict regulatory requirements, we could be required to pay fines or even close our facilities.**

Our facilities and manufacturing techniques generally must conform to standards that are established by government agencies, including those of European and other foreign governments, as well as the FDA, and, to a lesser extent, the U.S. Drug Enforcement Administration, or the DEA, and local health agencies. These regulatory agencies may conduct periodic audits of our facilities to monitor our compliance with applicable regulatory standards. If a regulatory agency finds that we fail to comply with the appropriate regulatory standards, it may impose fines on us or if such a regulatory agency determines that our non-compliance is severe, it may close our facilities. Any adverse action by an applicable regulatory agency could impair our ability to produce our products in a cost-effective and timely manner in order to meet our customers' demands. These regulatory agencies may also impose new or enhanced standards that would increase our costs as well as the risks associated with non-compliance. For example, we anticipate that the FDA may soon finalize and implement "good manufacturing practice," or GMP, regulations for nutritional supplements. GMP regulations would require supplements to be prepared, packaged and held in compliance with certain rules, and might require quality control provisions similar to those in the GMP regulations for drugs. While our manufacturing facilities for nutritional supplements have been subjected to, and passed, third party inspections against anticipated GMP standards, the ongoing compliance required in the event that GMP regulations are adopted would involve additional costs and would present new risks associated with any failure to comply with the regulations in the future.

**If we deliver products with defects, our credibility may be harmed, market acceptance of our products may decrease and we may be exposed to liability in excess of our product liability insurance coverage.**

The manufacturing and marketing of consumer and professional diagnostic products involve an inherent risk of product liability claims. In addition, our product development and production are extremely complex and could expose our products to defects. Any defects could harm our credibility and decrease market acceptance of our products. In addition, our marketing of vitamins and nutritional supplements may cause us to be subjected to various product liability claims, including, among others, claims that the vitamins and nutritional supplements have inadequate warnings concerning side effects and interactions with other substances. Potential product liability claims may exceed the amount of our insurance coverage or may be excluded from coverage under the terms of the policy. In the event that we are held liable for a claim for which we are not indemnified, or for damages exceeding the limits of our insurance coverage, that claim could materially damage our business and our financial condition.

**Our sales of brand name nutritional supplements have been trending downward since 1998 due to the maturity of the market segments they serve and the age of that product line and we may experience further declines in sales of those products.**

Our aggregate sales of all of our brand name nutritional products, including, among others, Ferro-Sequels, Stresstabs, Protegra, Posture, SoyCare, ALLBEE, and Z-BEC, have declined each year since 1998 until the year 2002, when they increased slightly as compared to 2001. We believe that these products have under-performed because they are, for the most part, aging brands with limited brand recognition that face increasing private label competition. The overall age of this product line means that we are subject to future distribution loss for under-performing brands, while our opportunities for new distribution on the existing product lines are limited. Though we did experience a slight increase in sales during 2002, the overall trend of declining sales for these products continued in 2003. As a result we do not expect significant sales growth of our existing brand name nutritional products and we may experience further declines in overall sales of our brand name nutritional products in the future.

**Our sales of specific vitamins and nutritional supplements could be negatively impacted by media attention or other news developments that challenge the safety and effectiveness of those specific vitamins and nutritional supplements.**

Most growth in the vitamin and nutritional supplement industry is attributed to new products that tend to generate greater attention in the marketplace than do older products. Positive media attention resulting from new scientific studies or announcements can spur rapid growth in individual segments of the market, and also impact individual brands. Conversely, news that challenges individual segments or products can have a negative impact on the industry overall as well as on sales of the challenged segments or products. Most of our vitamin and nutritional supplements products serve well-established market segments and, absent unforeseen new developments or trends, are not expected to benefit from rapid growth. A few of our vitamin and nutritional products are newer products that are more likely to be the subject of new scientific studies or announcements, which could be either positive or negative. News or other developments that challenge the safety or effectiveness of these products could negatively impact the profitability of our vitamin and nutritional supplements business.

**We could suffer monetary damages, incur substantial costs or be prevented from using technologies important to our products as a result of a number of pending legal proceedings.**

We are involved in various legal proceedings arising out of our consumer diagnostics, nutritional supplements and professional diagnostics business. Our material pending legal proceedings are:

- a counterclaim by Princeton BioMeditech Corporation, or PBM, against us in a patent infringement suit maintained by our subsidiaries, Inverness Medical Switzerland GmbH and Unipath Diagnostics, Inc., against PBM et. al. in which PBM alleges that we have breached various obligations to PBM arising out of its joint venture with us; and

- a suit brought by Quidel Corporation alleging that we are infringing U.S. Patent No. 4,943,522 and seeking a declaratory finding that Quidel does not infringe certain of our patents and certain other patents owned by co-defendant Armkel LLC and that the patents are invalid and/or unenforceable.

Because of the nature of our business, we may be subject at any particular time to commercial disputes, consumer product claims or various other lawsuits arising in the ordinary course of our business, including employment matters, and expect that this will continue to be the case in the future. Such lawsuits generally seek damages, sometimes in substantial amounts, for commercial or personal injuries allegedly suffered and can include claims for punitive or other special damages. An adverse ruling or rulings in one or more such lawsuits could, individually or in the aggregate, have a material adverse effect on our sales, operations or financial performance. In addition, we aggressively defend our patent and other intellectual property rights. This often involves bringing infringement or other commercial claims against third parties, such as our litigation against Acon Laboratories discussed in "Recent Developments" on page 27 of this report. These suits can be expensive and result in counterclaims challenging the validity of our patents and other rights. We cannot assure you that these lawsuits or any future lawsuits relating to our businesses will not have a material adverse effect on us.

**The profitability of our consumer products businesses may suffer if we are unable to establish and maintain close working relationships with our customers.**

For the year ended December 31, 2003 and the six months ended June 30, 2004, 69% and 65% of our net product sales were derived from our consumer products business. Our consumer products businesses rely to a great extent on close working relationships with our customers rather than long-term exclusive contractual arrangements. Customer concentration in these businesses is high, especially in our private label nutritional supplements business. In addition, customers of our branded and private label consumer products businesses purchase products through purchase orders only and are not obligated to make future purchases. We therefore rely on our ability to deliver quality products on time in order to retain and generate customers. If we fail to meet our customers' needs or expectations, whether due to manufacturing issues that affect quality or capacity issues that result in late shipments, we will harm our reputation and customer relationships and likely lose customers. If we are unable to maintain close working relationships with our customers, sales of all of our products and our ability to successfully launch new products could suffer. Additionally, the loss of a major customer and the failure to generate new accounts could significantly reduce our revenues or prevent us from achieving projected growth.

**The profitability of our consumer products businesses may suffer if Pfizer Inc. is unable to successfully market and sell its e.p.t pregnancy tests.**

Under the terms of a manufacturing, packaging and supply agreement that we entered into with Pfizer Inc., through one of its wholly-owned subsidiaries, Pfizer purchases its non-digital e.p.t pregnancy tests from us through June 6, 2009. Additionally, under the terms of a separate supply agreement, in December 2003, we began supplying Pfizer with a digital version of its e.p.t pregnancy test on a non-exclusive basis. The amount of revenues or profits that we generate under these agreements will depend on the volume of orders that we receive from Pfizer. As a result, if Pfizer is unable to successfully market and sell its e.p.t pregnancy tests, or if other events adversely affect the volume of Pfizer's sales of its e.p.t pregnancy tests, then our future revenues and profit may be adversely affected.

**Because our private label nutritional supplements business is a low margin business, its overall profitability may suffer significantly as a result of relatively small increases in raw material or other manufacturing costs.**

Our private label nutritional supplements business operates on low profit margins and we rely on our ability to efficiently mass produce nutritional supplements in order to make meaningful profits from this business. Changes in raw material or other manufacturing costs can drastically cut into or eliminate the profits generated from the sale of a particular product. For the most part, we do not have long-term supply contracts for our required raw materials and, as a result, our costs can increase with little notice. The private label nutritional supplements business is also highly competitive such that our ability to raise prices as a result of increased costs is limited. Customers generally purchase private label products via purchase order, not through long-term contracts, and they often purchase these products from the lowest bidder on a product by product basis. The internet has enhanced price competition among private label manufacturers through the advent of on-line auctions, where customers will auction off the right to manufacture a particular product to the lowest bidder.

**Retailer consolidation poses a threat to our existing retailer relationships and could result in lost revenue.**

In recent years there has been a rapid consolidation within the mass retail industry. Drug store chains, grocery stores and mass merchandisers, the primary purchasers of our consumer diagnostic products and vitamins and nutritional supplements, have all been subject to this trend. Because these customers purchase through purchase orders, consolidation can interfere with existing retailer

relationships, especially private label relationships, and result in the loss of major customers and significant revenue streams.

**Our financial condition or results of operations may be adversely affected by international business risks.**

Approximately 36% of our net revenues were generated from outside the United States for the year ended December 31, 2003. A significant number of our employees, including manufacturing, sales, support and research and development personnel, are located in foreign countries, including England, Ireland and Israel. Conducting business outside of the United States subjects us to numerous risks, including:

- increased costs or reduced revenue as a result of movements in foreign currency exchange rates;
- decreased liquidity resulting from longer accounts receivable collection cycles typical of foreign countries;
- lower productivity resulting from difficulties managing our sales, support and research and development operations across many countries;
- lost revenues resulting from difficulties associated with enforcing agreements and collecting receivables through foreign legal systems;
- lost revenues resulting from the imposition by foreign governments of trade protection measures;
- higher cost of sales resulting from import or export licensing requirements;
- lost revenues or other adverse affects as a result of economic or political instability in or affecting foreign countries in which we sell our products or operate; and
- adverse effects resulting from changes in foreign regulatory or other laws affecting the sales of our products or our foreign operations.

**Because our business relies heavily on foreign operations and revenues, changes in foreign currency exchange rates and our ability to convert currencies may negatively affect our financial condition and results of operations.**

Our business relies heavily on our foreign operations. Three of our manufacturing facilities are outside the United States, in Bedford, England, Galway, Ireland and Yavne, Israel. Approximately 36% of our net revenues were generated from outside the United States during the year ended December 31, 2003. Our Clearblue pregnancy test product sales have historically been much stronger outside the United States, with 75% of net product sales of these products coming from outside the United States during the year ended December 31, 2003. In addition, the Abbott rapid diagnostics product lines, which were acquired on September 30, 2003, generate a majority of their sales outside the United States. Furthermore, Persona is sold exclusively outside of the United States and our Orgenics professional diagnostic products have always been sold exclusively outside of the United States. Because of our foreign operations and foreign sales, we face exposure to movements in foreign currency exchange rates. Our primary exposures are related to the operations of our European subsidiaries. These exposures may change over time as business practices evolve and could result in increased costs or reduced revenue and could impact our actual cash flow.

**Our Orgenics subsidiary is located in Israel, and its operations could be negatively affected due to military or political tensions in the Middle East.**

Our wholly-owned subsidiary, Orgenics, which develops, manufactures and sells certain of our professional diagnostic products, is incorporated under the laws of the State of Israel. The

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administrative offices and development and manufacturing operations of our Orgenics business are located in Yavne, Israel. Although most of Orgenics's sales currently are to customers outside of Israel, political, economic and military conditions in Israel could nevertheless directly affect its operations. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. Despite its history of avoiding adverse effects, our Orgenics business could be adversely affected by any major hostilities involving Israel.

**Intense competition could reduce our market share or limit our ability to increase market share, which could impair the sales of our products and harm our financial performance.**

The medical products industry is rapidly evolving and developments are expected to continue at a rapid pace. Competition in this industry, which includes both our consumer diagnostics and professional diagnostics businesses, is intense and expected to increase as new products and technologies become available and new competitors enter the market. Our competitors in the United States and abroad are numerous and include, among others, diagnostic testing and medical products companies, universities and other research institutions. Our future success depends upon maintaining a competitive position in the development of products and technologies in our areas of focus. Our competitors may:

- develop technologies and products that are more effective than our products or that render our technologies or products obsolete or noncompetitive;
- obtain patent protection or other intellectual property rights that would prevent us from developing our potential products; or
- obtain regulatory approval for the commercialization of their products more rapidly or effectively than we do.

Also, the possibility of patent disputes with competitors holding foreign patent rights may limit or delay expansion possibilities for our diagnostics businesses in certain foreign jurisdictions. In addition, many of our existing or potential competitors have or may have substantially greater research and development capabilities, clinical, manufacturing, regulatory and marketing experience and financial and managerial resources.

The market for the sale of vitamins and nutritional supplements is also highly competitive. This competition is based principally upon price, quality of products, customer service and marketing support. There are numerous companies in the vitamins and nutritional supplements industry selling products to retailers such as mass merchandisers, drug store chains, independent drug stores, supermarkets, groceries and health food stores. As most of these companies are privately held, we are unable to obtain the information necessary to assess precisely the size and success of these competitors. However, we believe that a number of our competitors, particularly manufacturers of nationally advertised brand name products, are substantially larger than we are and have greater financial resources.

**The rights we rely upon to protect the intellectual property underlying our products may not be adequate, which could enable third parties to use our technology and would reduce our ability to compete in the market.**

Our success will depend in part on our ability to develop or acquire commercially valuable patent rights and to protect our intellectual property. Our patent position is generally uncertain and involves complex legal and factual questions. The degree of present and future protection for our proprietary rights is uncertain.

The risks and uncertainties that we face with respect to our patents and other proprietary rights include the following:

- the pending patent applications we have filed or to which we have exclusive rights may not result in issued patents or may take longer than we expect to result in issued patents;
- the claims of any patents which are issued may not provide meaningful protection;
- we may not be able to develop additional proprietary technologies that are patentable;
- the patents licensed or issued to us or our customers may not provide a competitive advantage;
- other parties may challenge patents or patent applications licensed or issued to us or our customers;
- patents issued to other companies may harm our ability to do business; and
- other companies may design around technologies we have patented, licensed or developed.

In addition to patents, we rely on a combination of trade secrets, nondisclosure agreements and other contractual provisions and technical measures to protect our intellectual property rights. Nevertheless, these measures may not be adequate to safeguard the technology underlying our products. If they do not protect our rights, third parties could use our technology and our ability to compete in the market would be reduced. In addition, employees, consultants and others who participate in the development of our products may breach their agreements with us regarding our intellectual property and we may not have adequate remedies for the breach. We also may not be able to effectively protect our intellectual property rights in some foreign countries. For a variety of reasons, we may decide not to file for patent, copyright or trademark protection or prosecute potential infringements of our patents. We also realize that our trade secrets may become known through other means not currently foreseen by us. Despite our efforts to protect our intellectual property, our competitors or customers may independently develop similar or alternative technologies or products that are equal or superior to our technology and products without infringing on any of our intellectual property rights or design around our proprietary technologies.

**Claims by other companies that our products infringe on their proprietary rights could adversely affect our ability to sell our products and increase our costs.**

Substantial litigation over intellectual property rights exists in both the consumer and professional diagnostic industries. We expect that our products and products in these industries could be increasingly subject to third party infringement claims as the number of competitors grows and the functionality of products and technology in different industry segments overlaps. Third parties may currently have, or may eventually be issued, patents on which our products or technology may infringe. Any of these third parties might make a claim of infringement against us. Any litigation could result in the expenditure of significant financial resources and the diversion of management's time and resources. In addition, litigation in which we are accused of infringement may cause negative publicity, have an impact on prospective customers, cause product shipment delays or require us to develop non-infringing technology, make substantial payments to third parties, or enter into royalty or license agreements, which may not be available on acceptable terms, or at all. If a successful claim of infringement was made against us and we could not develop non-infringing technology or license the infringed or similar technology on a timely and cost-effective basis, our revenue may decrease and we could be exposed to legal actions by our customers.

**We have initiated, and may need to further initiate, lawsuits to protect or enforce our patents and other intellectual property rights, which could be expensive and, if we lose, could cause us to lose some of our intellectual property rights, which would reduce our ability to compete in the market.**

We rely on patents to protect a portion of our intellectual property and our competitive position. In order to protect or enforce our patent rights, we may initiate patent litigation against third parties, such as infringement suits or interference proceedings. Litigation may be necessary to:

assert claims of infringement;

enforce our patents;

protect our trade secrets or know-how; or

determine the enforceability, scope and validity of the proprietary rights of others.

Currently, we have initiated a number of lawsuits against competitors who we believe to be selling products that infringe our proprietary rights. These current lawsuits and any other lawsuits that we initiate could be expensive, take significant time and divert management's attention from other business concerns. Litigation also puts our patents at risk of being invalidated or interpreted narrowly and our patent applications at risk of not issuing. Additionally, we may provoke third parties to assert claims against us.

Patent law relating to the scope of claims in the technology fields in which we operate is still evolving and, consequently, patent positions in our industry are generally uncertain. We may not prevail in any of these suits and the damages or other remedies awarded, if any, may not be commercially valuable. During the course of these suits, there may be public announcements of the results of hearings, motions and other interim proceedings or developments in the litigation. If securities analysts or investors perceive any of these results to be negative, our stock price could decline.

**Non-competition obligations and other restrictions will limit our ability to take full advantage of our management team, the technology we own or license and our research and development capabilities.**

Members of our management team have had significant experience in the diabetes field. In addition, technology we own or license may have potential applications to this field and our research and development capabilities could be applied to this field. However, in conjunction with our split-off from Inverness Medical Technology, Inc., or IMT, we agreed not to compete with IMT and Johnson & Johnson in the field of diabetes for 10 years. In addition, Mr. Ron Zwanziger, our Chairman, Chief Executive Officer and President, and two of our senior scientists, Dr. David Scott and Dr. Jerry McAleer, have entered into consulting agreements with IMT that impose similar restrictions. Further, our license agreement with IMT prevents us from using any of the licensed technology in the field of diabetes. As a result of these restrictions, we cannot pursue opportunities in the field of diabetes.

**You are unlikely to be able to exercise effective remedies against Arthur Andersen LLP, our former independent public accountants.**

Although we dismissed Arthur Andersen LLP as our independent public accountants in June 2002 and we now engage BDO Seidman, LLP, our consolidated financial statements as of December 31, 2001 and 2000 and for each of the three years in the period ended December 31, 2001, to the extent included in previously filed reports or registration statements, were audited by Arthur Andersen.

On March 14, 2002, Arthur Andersen was indicted on federal obstruction of justice charges arising from the government's investigation of Enron Corporation. On June 15, 2002, a jury in Houston, Texas found Arthur Andersen guilty of these federal obstruction of justice charges. In light of the jury verdict and the underlying events, Arthur Andersen subsequently substantially discontinued operations and dismissed essentially its entire workforce. You are therefore unlikely to be able to exercise effective

remedies or collect judgments against Arthur Andersen for any untrue statement of a material fact contained in the financial statements audited by Arthur Andersen or any omissions to state a material fact required to be stated in those financial statements.

**Our operating results may fluctuate due to various factors and, as a result, period-to-period comparisons of our results of operations will not necessarily be meaningful.**

Factors relating to our business make our future operating results uncertain and may cause them to fluctuate from period to period. Such factors include:

- the timing of new product announcements and introductions by us and our competitors;
- market acceptance of new or enhanced versions of our products;
- changes in manufacturing costs or other expenses;
- competitive pricing pressures;
- the gain or loss of significant distribution outlets or customers;
- increased research and development expenses;
- the timing of any future acquisitions;
- general economic conditions; or
- general stock market conditions or other economic or external factors.

Because our operating results may fluctuate from quarter to quarter, it may be difficult for us or our investors to predict our future performance by viewing our historical operating results.

**Our historical financial information relating to periods beginning prior to our split-off from IMT on November 21, 2001 may not be representative of our results as a separate company.**

On November 21, 2001, we were split-off from IMT and became an independent, publicly owned company as part of a transaction by which IMT was acquired by Johnson & Johnson. Prior to that time, we had been a majority owned subsidiary of IMT, and the businesses that we acquired in connection with the restructuring that preceded the split-off represented approximately 20% of IMT's net product sales during the calendar quarter concluded immediately prior to the split-off. The historical financial information relating to any periods beginning prior to November 21, 2001, included in our reports filed with the SEC, report on time periods prior to the split-off and reflect the operating history of our businesses when we were a part of IMT. As a result, the financial information may not reflect what our results of operations, financial position and cash flows would have been had we been a separate, stand-alone company during those periods. This financial information also may not reflect what our results of operations, financial position and cash flows will be in the future. This is not only related to the various risks associated with the fact that we have not been a stand-alone company for a long period of time, but also because:

- various adjustments and allocations have been made to produce these financial statements because IMT did not account for us as a single stand-alone business for those periods presented; and

the information, to the extent it does not report on a period ending on or after November 21, 2001, does not reflect many significant changes that occurred in our financial condition, capital structure and operations as a result of our separation from IMT.

The adjustments and allocations we made in preparing the financial information for any periods beginning prior to November 21, 2001 may not appropriately reflect our operations during those periods as if we had operated as a stand-alone company.

**Period-to-period comparisons of our operating results may not be meaningful due to our acquisitions.**

We have engaged in a number of significant acquisitions in recent years which make it difficult to analyze our results and to compare them from period to period, including the acquisitions of the Unipath business in December 2001, IVC in March 2002, Wampole in September 2002, Ostex in June 2003, ABI in August 2003 and the Abbott rapid diagnostics product lines in September 2003. Period-to-period comparisons of our results of operations may not be meaningful due to these acquisitions and are not indications of our future performance. Any future acquisitions will also make our results difficult to compare from period to period in the future.

**Our stock price may fluctuate significantly and stockholders who buy or sell our common stock may lose all or part of the value of their investment, depending on the price of our common stock from time to time.**

Our common stock has only been listed on the American Stock Exchange since November 23, 2001 and we have a limited market capitalization. As a result, we are currently followed by only a few market analysts and a portion of the investment community. Limited trading of our common stock may therefore make it more difficult for you to sell your shares.

In addition, our share price may be volatile due to our operating results, as well as factors beyond our control. During 2003, the sales price of our common stock ranged from $13.40 to $27.50, and during 2002, it ranged from $7.70 to $28.25. It is possible that in some future periods the results of our operations will be below the expectations of the public market. In any such event, the market price of our common stock could decline. Furthermore, the stock market may experience significant price and volume fluctuations, which may affect the market price of our common stock for reasons unrelated to our operating performance. The market price of our common stock may be highly volatile and may be affected by factors such as:

- our quarterly and annual operating results, including our failure to meet the performance estimates of securities analysts;
- changes in financial estimates of our revenues and operating results or buy/sell recommendations by securities analysts;
- the timing of announcements by us or our competitors of significant products, contracts or acquisitions or publicity regarding actual or potential results or performance thereof;
- changes in general conditions in the economy, the financial markets or the health care industry;
- government regulation in the health care industry;
- changes in other areas such as tax laws;
- sales of substantial amounts of common stock or the perception that such sales could occur;
- changes in investor perception of our industry, our businesses or our prospects;
- the loss of key employees, officers or directors; or
- other developments affecting us or our competitors.

**Anti-takeover provisions in our organizational documents and Delaware law may limit the ability of our stockholders to control our policies and effect a change of control of our company and prevent attempts by our stockholders to replace or remove our current management, which may not be in your best interests.**

There are provisions in our certificate of incorporation and bylaws that may discourage a third party from making a proposal to acquire us, even if some of our stockholders might consider the proposal to be in their best interests, and prevent attempts by our stockholders to replace or remove our current management. These provisions include the following:

- our certificate of incorporation provides for three classes of directors with the term of office of one class expiring each year, commonly referred to as a staggered board. By preventing stockholders from voting on the election of more than one class of directors at any annual meeting of stockholders, this provision may have the effect of keeping the current members of our board of directors in control for a longer period of time than stockholders may desire;

- our certificate of incorporation authorizes our board of directors to issue shares of preferred stock without stockholder approval and to establish the preferences and rights of any preferred stock issued, which would allow the board to issue one or more classes or series of preferred stock that could discourage or delay a tender offer or change in control;

- our certificate of incorporation prohibits our stockholders from filling board vacancies, calling special stockholder meetings or taking action by written consent;

- our certificate of incorporation provides for the removal of a director only with cause and by the affirmative vote of the holders of 75% or more of the shares then entitled to vote at an election of our directors; and

- our bylaws require advance written notice of stockholder proposals and director nominations.

Additionally, we are subject to Section 203 of the Delaware General Corporation Law, which, in general, imposes restrictions upon acquirers of 15% or more of our stock. Finally, the board of directors may in the future adopt other protective measures, such as a stockholder rights plan, which could delay, deter or prevent a change of control.

**Because we do not intend to pay dividends on our common stock, you will benefit from an investment in our common stock only if it appreciates in value.**

We currently intend to retain our future earnings, if any, to finance the expansion of our business and do not expect to pay any cash dividends on our common stock in the foreseeable future. In addition, our senior credit facility currently prohibits the payment of dividends and the indenture governing the terms of our senior subordinated notes restricts the amount of any dividends that we may pay. As a result, the success of your investment in our common stock will depend entirely upon any future appreciation. There is no guarantee that our common stock will appreciate in value or even maintain the price at which you purchased your shares.

**SPECIAL STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. You can identify these statements by forward-looking words such as "may," "could," "should," "would," "intend," "will," "expect," "anticipate," "believe," "estimate," "continue" or similar words. You should read statements that contain these words carefully because they discuss our future expectations, contain projections of our future results of operations or of our financial condition or state other "forward-looking" information. There may be events in the future that we are not able to predict accurately or control and that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. We caution investors that all forward-looking statements involve risks and uncertainties, and actual results may differ materially from those we discuss in this report. These differences may be the result of various factors, including those factors described in the "Certain Factors Affecting Future Results" section in this report and other risk factors identified from time to time in our periodic filings with the SEC. Some important additional factors that could cause our actual results to differ materially from those projected in any such forward-looking statements are as follows:

economic factors, including inflation and fluctuations in interest rates and foreign currency exchange rates, and the potential effect of such fluctuations on revenues, expenses and resulting margins;

competitive factors, including technological advances achieved and patents attained by competitors and generic competition;

domestic and foreign healthcare changes resulting in pricing pressures, including the continued consolidation among healthcare providers, trends toward managed care and healthcare cost containment and government laws and regulations relating to sales and promotion, reimbursement and pricing generally;

government laws and regulations affecting domestic and foreign operations, including those relating to trade, monetary and fiscal policies, taxes, price controls, regulatory approval of new products and licensing;

manufacturing interruptions, delays or capacity constraints or lack of availability of alternative sources for components for our products, including our ability to successfully maintain relationships with suppliers, or to put in place alternative suppliers on terms that are acceptable to us;

difficulties inherent in product development, including the potential inability to successfully continue technological innovation, complete clinical trials, obtain regulatory approvals in the United States and abroad, gain and maintain market approval of products and the possibility of encountering infringement claims by competitors with respect to patent or other intellectual property rights which can preclude or delay commercialization of a product;

significant litigation adverse to us including product liability claims, patent infringement claims and antitrust claims;

product efficacy or safety concerns resulting in product recalls or declining sales;

the impact of business combinations, including acquisitions and divestitures, such as our acquisitions of Applied Biotech, Inc. and the Abbott rapid diagnostics product lines, and organizational restructurings consistent with evolving business strategies;

our ability to satisfy the financial covenants and other conditions contained in our credit facilities;

our ability to obtain required financing on terms that are acceptable to us; and

the issuance of new or revised standards by the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the Public Company Accounting Oversight Board or the SEC.

The foregoing list sets forth many, but not all, of the factors that could impact upon our ability to achieve results described in any forward-looking statements. Readers should not place undue reliance on our forward-looking statements. Before you invest in our common stock, you should be aware that the occurrence of the events described above and elsewhere in this report could harm our business, prospects, operating results and financial condition. We do not undertake any obligation to update any forward-looking statements as a result of future events or developments.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those discussed in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments for speculative or trading purposes.

**Interest Rate Risk**

We are exposed to market risk from changes in interest rates primarily through our investing and financing activities. In addition, our ability to finance future acquisition transactions or fund working capital requirements may be impacted if we are not able to obtain appropriate financing at acceptable rates.

Our investing strategy, to manage interest rate exposure, is to invest in short-term, highly liquid investments. Our investment policy also requires investment in approved instruments with an initial maximum allowable maturity of eighteen months and an average maturity of our portfolio that should not exceed six months, with at least $500,000 cash available at all times. Currently, our short-term investments are in money market funds with original maturities of 90 days or less. At June 30, 2004, our short-term investments approximated market value.

At June 30, 2004, we had revolving lines of credit available to us of up to $50.0 million in the aggregate under our primary senior credit facility, of which none was used. We may repay any future borrowings under the revolving lines of credit at any time but in no event later than March 31, 2008. Borrowings under the revolving lines of credit bear interest at either (i) the London Interbank Offered Rate, or LIBOR, as defined in the credit agreement, plus applicable margins or, at our option, (ii) a floating Index Rate, as defined in the agreement, plus applicable margins. Applicable margins if we choose to use the LIBOR or the Index Rate can range from 2.75% to 3.75% or 1.50% to 2.50%, respectively, depending on the quarterly adjustments that are based on our consolidated financial performance, excluding IMN's.

We have an interest rate swap agreement with a bank in place, which was intended to provide us with limited protection from fluctuations in the LIBOR rate. Under the interest rate swap agreement, the LIBOR rate is at a minimum of 3.36% and a maximum of 5% and applies to $34.8 million of any of our U.S. Dollar denominated loans for the remaining term of the agreement. This interest rate swap agreement is effective through December 30, 2004.

As of June 30, 2004, the LIBOR and Index rates applicable under our primary senior credit facility were 1.37% and 4%, respectively. Assuming no changes in our leverage ratio, which would affect the margin of the interest rate under the senior credit agreement, the effect of interest rate fluctuations on

each $1.0 million borrowings under the revolving lines of credit in excess of the amounts covered under the interest rate swap agreement over the next twelve months is quantified and summarized as follows:

| If compared to the rate at June 30, 2004, | Interest Expense Increase |
|---|---|
| | (in thousands) |
| Interest rates increase by 1% point | $ 10 |
| Interest rates increase by 2% points | 20 |

Our subsidiary IMN has a credit agreement with its bank, under which it can borrow up to $15.0 million under a revolving credit commitment and $4.2 million under a term loan commitment, subject to specified borrowing base limitations. These IMN loans were set to mature on October 15, 2004, but subsequent to June 30, 2004 the maturity date was automatically extended to October 17, 2005. As of June 30, 2004, total borrowings outstanding under the credit agreement with the bank were $12.8 million. Borrowings under the revolving credit commitment and the term loan bear interest at either 1.5% above the bank's prime rate or, at IMN's option, at 3.75% above the Adjusted Eurodollar Rate used by the bank. As of June 30, 2004, the interest rate on $2.6 million of the outstanding borrowings was at the Adjusted Eurodollar Rate of 1.56% or 1.57% plus the spread of 3.75% and the interest rate on the remaining $10.2 million of the outstanding borrowings was at the prime rate of 4.00% plus the spread of 1.5%. The effect of interest rate fluctuations on the loans under IMN's credit agreement over the next twelve months, assuming the credit agreement is automatically extended for one year at the current maturity date, is quantified and summarized as follows:

| If compared to the rates at June 30, 2004, | Interest Expense Increase |
|---|---|
| | (in thousands) |
| Interest rates increase by 1% point | $ 119 |
| Interest rates increase by 2% points | 238 |

**Foreign Currency Risk**

We face exposure to movements in foreign currency exchange rates whenever we, or any of our subsidiaries, enter into transactions with third parties that are denominated in currencies other than our, or its, functional currency. Intercompany transactions between entities that use different functional currencies also expose us to foreign currency risk. For the three and six months ended June 30, 2004, the net impact of foreign currency changes on transactions was a loss of $185,000 and 151,000, respectively. Generally, we do not use derivative financial instruments or other financial instruments to hedge such economic exposures. However, if our foreign currency exchange exposure in these transactions continues to be significant, we may decide to use such instruments in the future.

Gross margins of products we manufacture at our European plants and sell in U.S. dollar are also affected by foreign currency exchange rate movements. Our gross margin on total net product sales was 39.1% for the three months ended June 30, 2004. If the U.S. dollar had been stronger by 1%, 5% or 10%, compared to the actual rates during the three months ended June 30, 2004, our gross margin on total net product sales would have been 39.2%, 39.7% and 40.3%, respectively. Our gross margin on total net product sales was 39.5% for the six months ended June 30, 2004. If the U.S. dollar had been stronger by 1%, 5% or 10%, compared to the actual rates during the six months ended June 30, 2004, our gross margin on total net product sales would have been 39.7%, 40.2% and 40.8%, respectively.

In addition, because a substantial portion of our earnings is generated by our foreign subsidiaries, whose functional currencies are other than the U.S. dollar (in which we report our consolidated financial results), our earnings could be materially impacted by movements in foreign currency exchange rates upon the translation of the earnings of such subsidiaries into the U.S. dollar. If the U.S. dollar had been stronger by 1%, 5% or 10%, compared to the actual average exchange rates used to

translate the financial results of our foreign subsidiaries, our net revenue and net income would have been lower by approximately the following amounts:

| | Approximate Decrease in | |
|---|---|---|
| | Net Revenue | Net Income |
| | (in thousands) | |
| **If during the three months ended June 30, 2004, the U.S. dollar was stronger by:** | | |
| 1% | $ 231 | $ 15 |
| 5% | 1,155 | 77 |
| 10% | 2,311 | 154 |

| | Net Revenue | Net Income |
|---|---|---|
| | (in thousands) | |
| **If during the six months ended June 30, 2004, the U.S. dollar was stronger by:** | | |
| 1% | $ 471 | $ 30 |
| 5% | 2,353 | 150 |
| 10% | 4,707 | 300 |

**ITEM 4. CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures*

Our management evaluated, with the participation of our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), the effectiveness of the design and operation of our company's disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this quarterly report on Form 10-Q. Based on this evaluation, our management, including the CEO and CFO, concluded that our company's disclosure controls and procedures were effective at that time. We and our management understand nonetheless that controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objectives, and our management necessarily was required to apply its judgment in evaluating and implementing possible controls and procedures. In reaching their conclusions stated above regarding the effectiveness of our disclosure controls and procedures, our CEO and CFO concluded that such disclosure controls and procedures were effective as of such date at the "reasonable assurance" level.

*Changes in Internal Control over Financial Reporting*

There was no change in our internal control over financial reporting that occurred during the period covered by this quarterly report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

*Quidel Corporation v. Inverness Medical Innovations, Inc. et als.*

In February, 2004, Quidel Corporation was served in Germany with a suit that our subsidiary, Inverness Medical Switzerland, GmbH (IMS), had filed in January 2004 seeking damages and injunction for infringement of certain of our patents. In response, on February 20, 2004, Quidel named us and our subsidiaries IMS and ABI as defendants in a suit filed by Quidel in the United States District Court for the Southern District of California. Quidel alleges that we are infringing U.S. Patent No. 4,943,522, a patent that was issued in 1990 titled "Lateral Flow, Non-Bibulous Membrane Assay Protocols." Quidel also asked the Court for a declaratory finding that Quidel does not infringe certain patents owned by IMS (the "May" and "Davis" patents) and certain other patents (the "Charlton" patents) owned by co-defendant Armkel LLC (now a part of Church & Dwight Co., Inc.) and that all these patents (the "Patents") are invalid and/or unenforceable. Quidel seeks injunctive relief and damages, and has indicated its intent to file a motion for preliminary injunction, the scope of which has not been disclosed. In early March 2004, we filed an answer claiming that Quidel's claims are without merit and a counterclaim seeking damages and injunctive relief for Quidel's infringement of the Patents. We also filed a separate action against Quidel in the same court alleging infringement of certain patents that we recently acquired from Abbott (the "Ching" patents) and seeking injunctive relief and damages. Quidel has filed counterclaims seeking further declarations that it does not infringe three other patents owned by Inverness. On or about June 29, 2004, the Court issued a claim construction order concerning one of the Charlton patents, following hearings in May in which the Court rejected various arguments made by Quidel in an effort to limit the scope of the asserted claims. The claim construction hearings on the other patents in the lawsuit are continuing, and the parties have begun discovery. We expect to move ahead with a motion for a preliminary injunction against Quidel's continued sale of infringing products, as well as to vigorously defend the Quidel claims.

*Other Pending and Potential Litigation and Proceedings*

Because of the nature of our business, we may be subject at any particular time to consumer product claims or various other lawsuits arising in the ordinary course of our business, including employment matters, and expect that this will continue to be the case in the future. Such lawsuits generally seek damages, sometimes in substantial amounts, for personal injuries or other commercial or employment claims. An adverse ruling in such a lawsuit could have a material adverse effect on our sales, operations or financial performance. In addition, we aggressively defend our patent and other intellectual property rights. This often involves bringing infringement or other commercial claims against third parties. In addition to infringement cases filed against several parties in the U.S., including a suit against Acon Laboratories in which the court recently found infringement and granted our motion for preliminary injunction, we have lawsuits pending in several other countries, including Germany, France and Australia, against approximately 15 parties whom we believe to be selling products that infringe our propriety rights. These suits can be expensive and result in counterclaims challenging the validity of our patents and other rights. The pending injunction against Acon is discussed further under "Recent Developments" on page 27 of this report.

**ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS**

On or about June 2, 2004, we issued a total of 155,209 shares of our common stock to the shareholders of Viva Diagnostika in exchange for all of the outstanding capital stock of Viva Diagnostika and an affiliated entity. No underwriters or underwriting discounts or commissions were involved. There was no public offering in connection with our sale to the shareholders of Viva Diagnostika and we believe that the transaction was exempt from the registration requirements of the

Securities Act of 1933, as amended, pursuant to Regulation S promulgated thereunder because each such shareholder of Viva Diagnostika (i) certified to us that he or she was not a "U.S. person" as such term is defined in Regulation S and was not acquiring the stock for the account or benefit of a "U.S. Person"; (ii) agreed that any resale of the stock shall be in accordance with the provisions of Regulation S, pursuant to registration under the Act or pursuant to an available exemption from registration; (iii) agreed not to engage in any hedging transactions with regard to such stock unless in compliance with the Securities Act; and (iv) acknowledged and agreed, in accordance with Regulation S, that we would refuse to register any transfer of shares of the stock unless such transfer is made in accordance with the provisions of Regulation S, pursuant to registration under the Securities Act or pursuant to an available exemption from registration. We also agreed to subsequently register the resale of the shares of stock issued to the shareholders of Viva Diagnostika on a registration statement on Form S-3.

On or about June 10, 2004, we issued 2,695 shares of common stock upon the cashless exercise of warrants pursuant to an exemption afforded by Section 3(a)(9) of the Securities Act of 1933, as amended.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

At the annual meeting of stockholders of our company held on May 26, 2004, Robert P. Khederian, John A. Quelch, David Scott, Ph.D. and Peter Townsend were elected as Class III directors of our company. The other directors whose term of office continued after the meeting were: Ernest A. Carabillo, Jr., John F. Levy, Jerry McAleer, Ph. D., Carol R. Goldberg, Alfred M. Zeien and Ron Zwanziger.

The following table summarizes the votes for, against or withheld, as well as the number of broker non-votes with regard to the election of Class III directors at our annual meeting of stockholders:

**Class: Common Shares**

| Matter | For | Against | Withheld | Broker Non-Votes |
|---|---|---|---|---|
| Election of: | | | | |
| Mr. Khederian | 15,265,216 | 0 | 230,589 | 0 |
| Mr. Quelch | 15,462,408 | 0 | 33,397 | 0 |
| Dr. Scott | 15,480,397 | 0 | 15,408 | 0 |
| Mr. Townsend | 15,463,124 | 0 | 32,681 | 0 |

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

**a.**

**Exhibits:**

| Exhibit No. | Description |
|---|---|
| **4.1 | First Supplemental Indenture, dated as of June 15, 2004, among Inverness Medical Innovations, Inc., the Guarantors, Advantage Diagnostics Corporation and U.S. Bank Trust National Association, as Trustee. |

| | |
|---|---|
| **10.1 | Sixth Amendment and Consent to Second Amended and Restated Credit Agreement, dated as of June 1, 2004, by and among General Electric Capital Corporation, as Agent and lender, Inverness Medical Innovations, Inc., Wampole Laboratories, LLC, Inverness Medical (UK) Holdings Limited, the other Credit Parties signatory thereto, Merrill Lynch Capital, a division of Merrill Lynch Business Financial Services Inc., as documentation agent, co-syndication agent and Lender, UBS Securities, LLC, as co-syndication agent and lender, and the lenders signatory thereto from time to time. |
| **10.2 | Seventh Amendment and Consent to Second Amended and Restated Credit Agreement, dated as of July 27, 2004 by and among General Electric Capital Corporation, as Agent and lender, Inverness Medical Innovations, Inc., Wampole Laboratories, LLC, Inverness Medical (UK) Holdings Limited, the other Credit Parties signatory thereto, Merrill Lynch Capital, a division of Merrill Lynch Business Financial Services Inc., as documentation agent, co-syndication agent and Lender, UBS Securities, LLC, as co-syndication agent and lender, and the lenders signatory thereto from time to time. |
| *31.1 | Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| *31.2 | Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| *32.1 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

*
filed herewith

**
previously filed

**b.**

**Reports on Form 8-K:**

On April 29, 2004, we filed a Current Report on Form 8-K dated April 29, 2004 (Items 12 and 7) in order to furnish our press release entitled "Inverness Medical Innovations Announces First Quarter 2004 Results."

On June 7, 2004, we filed a Current Report on Form 8-K dated January 2, 2004 (Items 7 and 9) in order to furnish our press release entitled "Inverness Medical Innovations Acquires German Distributor, Viva Diagnostika."

**SIGNATURE**

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.

INVERNESS MEDICAL INNOVATIONS, INC.

Date: February 11, 2005

/s/ CHRISTOPHER J. LINDOP

Christopher J. Lindop
Chief Financial Officer and an authorized officer

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