

SRI SURGICAL EXPRESS INC
Form 10-Q
May 14, 2003
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **MARCH 31, 2003**

OR

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

For the transition period from _____ to _____

Commission File Number: 000-20997

SRI/SURGICAL EXPRESS, INC.

(Exact name of Registrant as specified in its Charter)

Florida
(State of Incorporation)

59-3252632
(I.R.S. Employer
Identification No.)

12425 Race Track Road
Tampa, Florida 33626
(Address of Principal Executive Offices)

(813) 891-9550
(Registrant's Telephone Number)

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Indicate by check 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 No

Number of outstanding shares of each class of Registrant's Common Stock as of March 31, 2003:

Common Stock, par value \$.001 6,268,877

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SRI/SURGICAL EXPRESS, INC.
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)
(unaudited)

	Three Months Ended	
	March 31, 2003	March 31, 2002
Revenues	\$ 21,460	\$ 21,755
Cost of revenues	15,636	15,215
Gross profit	5,824	6,540
Distribution expenses	1,535	1,432
Selling and administrative expenses	3,662	3,738
Income from operations	627	1,370
Unrealized gain on derivative instruments		65
Interest expense, net	319	238
Income before income taxes	308	1,197
Income tax expense	116	449
Net income	\$ 192	\$ 748
Net income available for common shareholders, basic	\$ 0.03	\$ 0.12
Net income available for common shareholders, diluted	\$ 0.03	\$ 0.12
Weighted average common shares outstanding, basic	6,269	6,417
Weighted average common shares outstanding, diluted	6,274	6,618

The accompanying notes are an integral part of these financial statements

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SRI/SURGICAL EXPRESS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands)

	March 31, 2003	December 31, 2002
	(unaudited)	
ASSETS		
Cash and cash equivalents	\$ 557	\$ 537
Accounts receivable, net	10,583	10,289
Inventories, net	6,846	6,977
Prepaid expenses and other assets	3,052	2,953
Reusable surgical products, net	24,259	25,642
Property, plant and equipment, net	39,727	40,264
Goodwill, net	5,244	5,244
	<hr/>	<hr/>
Total assets	\$ 90,268	\$ 91,906
	<hr/>	<hr/>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Notes payable to bank	\$ 14,006	\$ 15,452
Accounts payable	4,923	5,429
Employee related accrued expenses	1,031	913
Other accrued expenses	1,260	1,408
Obligation under capital lease	4,606	4,455
Bonds payable	9,700	9,700
Deferred tax liability, net	1,704	1,704
	<hr/>	<hr/>
Total liabilities	37,230	39,061
Shareholders' equity		
Preferred stock-authorized 5,000,000 shares of \$0.001 par value; no shares issued and outstanding at March 31, 2003 and December 31, 2002		
Common stock-authorized 30,000,000 shares of \$0.001 par value; issued and outstanding 6,268,877 at March 31, 2003 and December 31, 2002	6	6
Additional paid-in capital	29,424	29,423
Retained earnings	23,608	23,416
	<hr/>	<hr/>
Total shareholders' equity	\$ 53,038	\$ 52,845
	<hr/>	<hr/>
Total liabilities and shareholders' equity	\$ 90,268	\$ 91,906
	<hr/>	<hr/>

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

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SRI/SURGICAL EXPRESS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(unaudited)

	Three Months Ended	
	March 31, 2003	March 31, 2002
Cash flows from operating activities		
Net income	\$ 192	\$ 748
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,025	750
Amortization of reusable surgical products	1,174	892
Provision for reusable surgical products shrinkage	413	506
Unrealized gain on derivative instruments		(65)
Change in assets and liabilities:		
Accounts receivable, net	(294)	993
Inventories, net	131	(98)
Prepaid expenses and other assets	(99)	311
Accounts payable	(506)	(2,499)
Employee related and other accrued expenses	(29)	82
Net cash provided by operating activities	<u>2,007</u>	<u>1,620</u>
Cash flows from investing activities		
Purchases of property, plant and equipment	(309)	(1,810)
Purchases of reusable surgical products	(204)	(192)
Net cash used in investing activities	<u>(513)</u>	<u>(2,002)</u>
Cash flows from financing activities		
Net (repayment) on notes payable to bank	(1,446)	(736)
Payments on obligation under capital lease	(28)	(26)
Net proceeds from issuance of common stock		1,181
Net cash provided by (used in) financing activities	<u>(1,474)</u>	<u>419</u>
Increase in cash and cash equivalents	20	37
Cash and cash equivalents at beginning of period	537	538
Cash and cash equivalents at end of period	<u>\$ 557</u>	<u>\$ 575</u>
Supplemental cash flow information		
Cash paid for interest	<u>\$ 201</u>	<u>\$ 186</u>
Cash paid for income taxes	<u>\$ 25</u>	<u>\$ (9)</u>
Supplemental schedule of non-cash activities		
Assets acquired under capital lease	\$ 179	\$

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Income tax benefit of stock options exercised	<u> </u>	<u> </u>
	\$	\$ 192
	<u> </u>	<u> </u>

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

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SRI/SURGICAL EXPRESS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE A BASIS OF PRESENTATION

The accompanying unaudited condensed financial statements of SRI/Surgical Express, Inc. (the Company) have been prepared in accordance with the Securities and Exchange Commission's instructions to Form 10-Q and, therefore, omit or condense footnotes and certain other information normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States. The accounting policies followed for quarterly financial reporting conform with accounting principles generally accepted in the United States for interim financial statements and include those accounting policies disclosed in the Company's Form 10-K for the year ended December 31, 2002 filed with the Securities and Exchange Commission. In the opinion of management, all adjustments of a normal recurring nature that are necessary for a fair presentation of the financial information for the interim periods reported have been made. The results of operations for the three months ended March 31, 2003 are not necessarily indicative of the results that can be expected for the entire year ending December 31, 2003. The unaudited financial statements should be read in conjunction with the financial statements and the notes thereto included in the Form 10-K.

The Company operates on a 52-53 week fiscal year ending the Sunday nearest December 31. There are 13 weeks included for the three month periods ended March 31, 2003 and March 31, 2002, respectively.

NOTE B SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Consolidated Financial Statement Presentation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary Realty Trust beginning in December 2002. All significant intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Concentration of Credit Risk

The Company has accounts receivable from hospitals and surgery centers. The Company does not believe that there are substantial credit risks associated with those receivables. The Company does not require any form of collateral from the hospitals and surgery centers. The allowance for doubtful accounts as of March 31, 2003 and December 31, 2002 was approximately \$114,000 and \$101,000, respectively. The Company's write-offs for uncollectible accounts are insignificant to its results of operations. The Company does not charge interest on trade receivables.

Table of Contents*Inventories*

Inventories, consisting principally of consumables, supplies, and disposable surgical products, are valued at the lower of cost or market, with cost being determined on the first-in, first-out method. As of March 31, 2003 and December 31, 2002, inventory consists of the following:

	March 31, 2003	December 31, 2002
Raw materials	\$ 3,496,229	\$ 3,453,313
Work in progress	199,926	81,211
Finished goods	3,379,865	3,652,355
	<u>7,076,020</u>	<u>7,186,879</u>
Inventory reserve	(229,799)	(210,299)
	<u>\$ 6,846,221</u>	<u>\$ 6,976,580</u>

Reusable Surgical Products

Reusable surgical products are stated at cost. Amortization is computed on a basis similar to the units of production method. Estimated useful lives are based on the estimated total number of available uses for each product. The expected total available usage for its products using the three principal fabrics (accounting for 85% of its products) is 75, 100, and 125 uses based on several factors. Accumulated amortization as of March 31, 2003 and December 31, 2002 was approximately \$12.7 million and \$12.5 million, respectively.

As of March 31, 2003 and December 31, 2002, the Company had reserves for shrinkage and obsolescence of approximately \$1.0 million, respectively.

Property Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation and amortization are computed by the straight-line method with a half-year convention over the estimated useful lives of the assets, or for leasehold improvements for the term of the related leases.

Goodwill

Goodwill of approximately \$6,018,000 arising from acquisitions is stated at cost, net of accumulated amortization of approximately \$774,000. Prior to January 1, 2002, goodwill had been amortized on a straight-line basis over periods ranging from twenty to thirty years.

As of January 1, 2002 the Company tests goodwill for impairment using the two-step process prescribed in Statement 142. SRI's adoption of Statement 142 in 2002 did not affect its results of operations or financial position. Pursuant to Statement 142, SRI must test its intangible assets for impairment annually, or more frequently, if indicators of impairment arise.

Revenue Recognition

Revenues are recognized as the agreed upon products and services are delivered, generally daily. Confirmation of deliveries is evidenced by a signed and dated packing slip and a randomly generated delivery confirmation number. The Company's contractual relationships with its customers primarily are evidenced in purchase orders or service agreements with varying terms of one to five years, which are cancelable by either party, generally with a 90-day notice.

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Substantially all of the reusable surgical products provided to a customer are owned by the Company. Certain reusable instruments that are included in the comprehensive surgical procedure-based delivery and retrieval service are provided to the Company by a third party agent for a fee. In accordance with Emerging Issues Task Force Abstract No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, management has concluded that the Company is acting as a principal in this arrangement and has reported the revenue gross for the comprehensive surgical procedure-based delivery and retrieval service. The fee charged by the third party agent to the Company is included in cost of revenues in the Company's consolidated statements of income.

Income Taxes

Income taxes have been provided using the liability method in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*.

Fair Value of Financial Instruments

The carrying amounts of cash and cash equivalents approximate fair value because of the short-term nature of these items. The fair value of the Company's long-term debt approximates its carrying amount as the interest rates change with market interest rates.

Net Income per Common Share

Basic net income per share is calculated by dividing net income available for common shareholders by the weighted average number of common shares outstanding during the period. Diluted net income per share is calculated by dividing net income by the weighted average number of common and potential common shares outstanding during the period. Potential common shares consist of the dilutive effect of outstanding options, calculated using the treasury stock method.

Stock Based Compensation

The Company accounts for stock-based compensation arrangements under the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25). In 1995, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*. Under Statement 123, the Company may elect to recognize stock-based compensation expense based on the fair value of the awards or continue to account for stock-based compensation under APB 25, and disclose in the consolidated financial statements the effects of Statement 123 as if the recognition provisions were adopted.

If the Company recognized compensation expense based upon the fair value at the grant date for awards under its option plans consistent with the methodology prescribed by Statement 123, the Company's net income and earnings per share would be reduced to the pro forma amounts indicated below:

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		Three Months Ended	
		March 31, 2003	March 31, 2002
Net income	As reported	\$ 192	\$ 748
Compensation expense, net of tax	Pro forma	(209)	(198)
	Pro forma	\$ (17)	\$ 550
Basic income per share available for common shareholders	As reported	\$ 0.03	\$ 0.12
Compensation expense, net of tax	Pro forma	(0.03)	(0.03)
	Pro forma	\$	\$ 0.09
Diluted income per share	As reported	\$ 0.03	\$ 0.12
Compensation expense, net of tax	Pro forma	(0.03)	(0.03)
	Pro forma	\$	\$ 0.09

Recent Accounting Pronouncements

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity* (including Certain Costs Incurred in a Restructuring). Liabilities for these costs are now generally recognized when incurred rather than at the date an entity commits to an exit plan. The provisions of SFAS No. 146 are effective, on a prospective basis, for exit or disposal activities initiated by the Company after December 31, 2002. The Company does not believe that SFAS No. 146 will materially affect its future results of operations.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*, which amends FASB Statement No. 123. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation. SFAS 148 also amends the disclosure requirements of SFAS 123 to require more frequent disclosures in financial statements concerning the effect of stock-based compensation. The effective date of SFAS 148 is for fiscal years ending after December 15, 2002. The Company followed APB 25 and related interpretations in accounting for its employee stock options for the three month periods ended March 31, 2003 and March 31, 2002 and hence there was no impact on the Company's consolidated financial position and results of operations.

Comprehensive Income

In June 1997, the FASB issued Statement of Financial Accounting Standards No. 130, *Reporting Comprehensive Income*. Statement 130 requires that total comprehensive income and comprehensive income per share be disclosed with the same prominence as net income and earnings per share. Comprehensive income is defined as changes in shareholders' equity exclusive of transactions with owners such as capital contributions and dividends and specifically excluded items such as deferred compensation. The Company adopted this standard in 1998. The Company did not have any items of other comprehensive income on which to report in any of the years presented.

Reclassifications

Certain prior year amounts have been reclassified in order to conform to the 2003 presentation. Certain employee salaries, benefits and related expenses have been reclassified from Cost of Revenue into Selling and Administrative expenses.

Table of Contents*Line of Credit*

The Company's outstanding balance under its \$45.0 million revolving credit facility was approximately \$14.0 million and \$15.5 million on March 31, 2003 and December 31, 2002, respectively.

The credit facility is secured by substantially all of the Company's assets and has a maturity date of June 30, 2003 (See Liquidity and Capital Resources). The amount available under the Company's revolving credit facility at March 31, 2003 and December 31, 2002 was \$31.0 million and \$29.5 million respectively, subject to compliance with certain covenants. The facility's interest rate varies between 225 and 275 basis points over LIBOR (1.306% as of March 31, 2003), depending on the Company's leverage. The credit facility requires the Company to maintain (a) minimum net worth of not less than \$37.0 million plus 75% of cumulative net income for each fiscal quarter beginning with the fiscal quarter ending March 31, 2000; (b) a leverage ratio of not more than 2.5 to 1.0; and (c) a fixed charge coverage ratio of 2.25 to 1.0 through December 31, 2002, and 2.35 to 1.0 thereafter. The credit facility restricts the Company in paying dividends, engaging in acquisition transactions, incurring additional indebtedness, and encumbering its assets. The Company complied with all requirements of the credit facility as of March 31, 2003.

The credit facility allows the Company to repurchase up to \$5 million of its stock from time to time through open market purchases at prevailing market prices. As of March 31, 2003, the Company had repurchased 229,800 shares of its common stock, at an aggregate cost of approximately \$2.1 million during the period from 2000 to 2002. No shares were repurchased in the first quarter of 2003.

NOTE C EARNINGS PER SHARE

The following table sets forth the Company's computation of basic and diluted earnings per share before the cumulative effect of a change in accounting policy:

	Three Months Ended	
	March 31, 2003	March 31, 2002
	(In thousands, except per share data)	
	(unaudited)	
Basic		
Numerator:		
Net Income	\$ 192	\$ 748
Denominator:		
Weighted average shares outstanding	6,269	6,417
Income per common share, basic	\$ 0.03	\$ 0.12
Diluted		
Numerator:		
Net Income	\$ 192	\$ 748
Denominator:		
Weighted average shares outstanding	6,269	6,417
Effect of dilutive securities - Employee stock options	5	201
	6,274	6,618
Income per common share, diluted	\$ 0.03	\$ 0.12

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Options to purchase 959,000 and 265,000 shares of common stock for the three month periods ended March 31, 2003 and March 31, 2002, respectively, were not included for all or a portion of the computation of diluted net income per common share, because the options' exercise prices were greater than the average market price of the common shares and therefore the effect would be anti-dilutive.

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Item 2.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

The following discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto included elsewhere in this report. This discussion and analysis contains trend analysis and might contain forward-looking statements. These statements are based on current expectations and actual results might differ materially. Among the factors that could cause actual results to vary are those described in this Overview section.

The Company's revenues are derived from providing hospitals and surgery centers with reusable gowns, towels, drapes, basins, and instruments for use in surgical procedures through a daily comprehensive surgical procedure-based delivery and retrieval system, and also from the sale of disposable surgical products that supplement its reusable surgical product service. From 11 reprocessing facilities and one disposable products facility, the Company collects, sorts, cleans, inspects, packages, sterilizes and delivers its reusable products on a just-in-time basis. The Company offers an integrated closed-loop reprocessing service that uses two of the most technologically advanced reusable textiles: (i) a GORE® Surgical Barrier Fabric* for gowns and drapes that is breathable yet liquidproof and provides a viral/bacterial barrier and (ii) an advanced microfiber polyester surgical fabric for gowns and drapes that is liquid and bacterial resistant. The Company also offers state of the art reusable laparoscopic instruments from Aesculap, Inc., one of the oldest and largest worldwide suppliers of surgical instruments. The surgical instruments are designed either to be taken apart or with flush ports to allow complete cleaning and decontamination. The Company's revenue growth is primarily affected by the number of customers, the number and type of surgical procedures it services for each customer, and pricing for its various types of surgical packs.

In recent years, the Company made investments in staff, facility expansions, and additional reusable surgical products in anticipation of revenue growth. As previously disclosed, the Company has endured a period in which its revenues have been adversely affected by the competitive market for its products and services, including price reductions on some accounts to retain customers, as well as the continuing impact of lost customers. Revenue losses from these factors have been partially offset by continued growth in the Company's instrument business as revenue increased by \$1.0 million to \$2.6 million in the three months ended March 31, 2003, compared to \$1.6 million in the three months ended March 31, 2002.

The Company recently announced a new ten-year joint marketing agreement with Aesculap, Inc. The agreement, which renews the relationship that began in April 2000 provides for the Company and Aesculap to jointly market the Company's Instrument Express program and Aesculap's PCMS Services. The agreement provides for Aesculap to furnish and repair all instruments that the Company requires and for the Company to handle delivery, retrieval and reprocessing of the instruments as part of its Instrument Express Program. The parties mutually establish customer pricing for the instruments. The Company pays Aesculap an agreed amount per procedure for instruments furnished under the program, with provisions for potential adjustments to that pricing if a party fails to realize targeted gross margins from the arrangement. The Company's Instrument Express Program provides hospitals with a comprehensive procedure-based delivery and retrieval service of surgical instruments. Aesculap's PCMS Services provides customers with procedure specific instrument sets for use in laparoscopic, arthroscopic, and general surgical applications and certain related repair and maintenance services on a per procedure basis.

**GORE® Surgical Barrier Fabric is a registered trademark of W.L. Gore & Associates, Inc.*

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Critical Accounting Policies

The preparation of consolidated financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make judgments, assumptions, and estimates that affect the amounts reported in the Company's consolidated financial statements and accompanying notes. Note B to the Company's consolidated financial statements describes the significant accounting policies and methods that the Company uses in preparing its consolidated financial statements. Estimates are used for, but not limited to, the accounting for the allowance for doubtful accounts, amortization of reusable products, shrinkage and obsolescence of inventory and reusable surgical products, and goodwill impairments. Actual results could differ from these estimates. The following critical accounting policies are impacted significantly by judgments, assumptions and estimates used in the preparation of the consolidated financial statements:

Allowance for Doubtful Accounts. The Company's allowance for doubtful accounts is based on its assessment of the collectibility of specific customer accounts and the overall aging of its accounts receivable. SRI would be required to increase this allowance, adversely affecting net income, if a major customer's creditworthiness deteriorates or actual defaults run at a rate higher than historical experience.

Amortization of Reusable Products. The Company states its reusable surgical products at cost and computes amortization on a basis similar to the units of production method. The Company estimates the useful lives for each product based on its estimate of the total number of uses for which the product will be available. SRI estimates that its products using its three principal fabrics (accounting for 85% of its products) will be available for 75, 100, and 125 uses based on several factors, including the Company's actual experience with these products over the past ten years. If its actual use experience with these products is shorter than these assumptions, the Company's amortization rates for reusable products would increase, therefore adversely affecting its net income.

Reserves for Shrinkage and Obsolescence for Reusable Surgical Products. SRI determines its reserves for shrinkage and obsolescence of its reusable products by tracking those products with its bar-coding system. Based on historical experience, the Company believes that any products not scanned by the system for a 210-day period are lost. If actual losses exceed management's estimates, the Company's shrinkage reserve would increase, adversely affecting its net income.

Reserves for Shrinkage and Obsolescence for Inventories. SRI determines its reserves for shrinkage and obsolescence of its inventories based on historical results, including the results of cycle counts performed during the year, and the evaluation of the aging of finished goods of reusable surgical products and disposable packs. If actual losses exceed management's estimates and assumptions, the Company's inventory reserves would increase, adversely affecting its net income.

Impairment of Goodwill and other Intangible Assets. The Company adopted Statement of Financial Accounting Standards No.142, *Goodwill and Other Intangible Assets*, as of January 1, 2002. The Company tests goodwill for impairment using the two-step process prescribed in Statement 142. SRI's adoption of Statement 142 in 2002 did not affect its results of operations or financial position. Pursuant to Statement 142, SRI must test its intangible assets for impairment annually or more frequently if indicators of impairment arise. Any impairment would adversely affect SRI's net income.

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The following table sets forth for the periods shown the percentage of revenues represented by certain items reflected in the statement of income of the Company.

	Three Months Ended	
	March 31, 2003	March 31, 2002
Revenues	100.0	100.0
Cost of revenues	72.9	69.9
Gross profit	27.1	30.1
Distribution expenses	7.1	6.6
Selling and administrative expenses	17.1	17.2
Income from operations	2.9	6.3
Unrealized gain on derivative instruments		0.3
Interest expense, net	1.5	1.1
Income before income taxes	1.4	5.5
Income tax expense	0.5	2.1
Net income	0.9	3.4

Three Months Ended March 31, 2003 Compared to Three Months Ended March 31, 2002

Revenues. Revenues decreased \$295,000, or 1.4%, to \$21.5 million in the three months ended March 31, 2003, from \$21.8 million in the three months ended March 31, 2002. Revenue decreases are attributable to the competitive market for the Company's products and services, including price reductions and the loss of some customer accounts. These adverse impacts were partially offset by continued growth in the Company's instrument programs.

Gross Profit. Gross profit decreased \$716,000, or 10.9%, to \$5.8 million in the three months ended March 31, 2003, from \$6.5 million in the three months ended March 31, 2002. As a percentage of revenues, gross profit decreased by 3.0% to 27.1% in the three months ended March 31, 2003, from 30.1% in the three months ended March 31, 2002. The decrease in gross profit reflects increased overhead and the impact of price reductions and customer account losses. Additionally, depreciation expense for the quarter ending March 31, 2003 increased approximately \$260,000 due to the purchase in December 2002 of the interest in SRI Realty Trust, Inc. from an unrelated third party and the resulting elimination of the prior operating leases for two of the Company's processing facilities.

Distribution Expenses. Distribution expenses increased \$103,000, or 7.2%, to \$1.5 million in the three months ended March 31, 2003, from \$1.4 million in the three months ended March 31, 2002. As a percentage of revenues, distribution expenses increased by 0.5% to 7.1% in the three months ended March 31, 2003, from 6.6% in the three months ended March 31, 2002. The increase in distribution expenses resulted primarily from increased vehicle lease, operation, and insurance expense.

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Selling and Administrative Expenses. Selling and administrative expenses decreased \$76,000, or 2.0%, to \$3.7 million in the three months ended March 31, 2003 and 2002, respectively. As a percentage of revenues, selling and administrative expenses decreased 0.1% to 17.1% in the three months ended March 31, 2003, from 17.2% in the three months ended March 31, 2002. The Company's selling and administrative expenses decreased primarily due to reduced travel and other expenses as a result of cost savings initiatives, and was partially offset by increased professional fees, marketing and administrative fees for group purchasing organization accounts, and insurance expenses.

Income from Operations. Income from operations decreased \$743,000, or 54.2%, to \$627,000 in the three months ended March 31, 2003, from \$1.4 million in the three months ended March 31, 2002. As a percentage of revenues, income from operations decreased 3.4% to 2.9% for the three months ended March 31, 2003, from 6.3% for the three months ended March 31, 2002.

Derivative Instruments. The Company had guaranteed two interest rate swaps of a third party until April 2002, when those swaps were terminated. Pursuant to SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the Company recognized an unrealized gain of \$65,000 in the three months ended March 31, 2002.

Interest Expense, Net. Interest expense increased \$81,000 to \$319,000 in the three months ended March 31, 2003, from \$238,000 in the three months ended March 31, 2002; primarily due to expenses associated with the bond financing on two of the Company's processing facilities that were formerly charged to operating lease arrangements.

Income Tax Expense. Income tax expense decreased \$333,000 to \$116,000 in the three months ended March 31, 2003, compared to \$449,000 in the three months ended March 31, 2002. The Company's effective tax rate was 37.5%.

Liquidity and Capital Resources

The Company's principal sources of capital have been cash flows from operations and borrowings under its working capital loan facility.

The Company's positive cash flow provided by operating activities was \$2.0 million during the three months ended March 31, 2003, compared to \$1.6 million during the three months ended March 31, 2002. The Company's cash flow increased during this time period in comparison to the prior period notwithstanding reduced net income, principally because of higher depreciation and amortization expenses and reduction of accounts payable.

The Company's net cash used in investing activities decreased to \$513,000 in the three months ended March 31, 2003 from \$2.0 million in the three months ended March 31, 2002. These expenditures were funded from cash provided by operating activities and borrowings under the Company's revolving credit facility. The reduction is primarily due to decreased purchases of property, plant and equipment.

The Company spent \$309,000 and \$1.8 million in the three months ended March 31, 2003 and 2002, respectively, on purchases of property, plant and equipment. The Company spent \$204,000 and \$192,000 in the three months ended March 31, 2003 and 2002, respectively, on purchases of reusable surgical products. The Company has a procurement agreement through August 2008 with Standard Textile Co., Inc. under which the Company agrees to purchase 90% of its reusable surgical products from Standard Textile. On a monthly basis, for the subsequent twelve months, the Company forecasts its anticipated product requirements from Standard Textile. The Company anticipates a substantial decline in its product requirement for 2003. The Company estimates that its expenditures for new carts and reusable surgical products will be approximately \$100,000 per month for the remainder of the year, although this amount will fluctuate depending on the growth of its business.

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The Company's revolving credit facility allows the Company to repurchase up to \$5 million of its stock from time to time through open market purchases at prevailing market prices. The Company began repurchasing shares in 2000. As of December 31, 2002, the Company had repurchased 229,800 shares of its common stock, at an aggregate cost of approximately \$2.1 million between 2000 and 2002. The Company has not repurchased shares since December 2002.

As of March 31, 2003, the Company had cash of approximately \$557,000, as well as additional amounts available under its credit facility. The credit facility is subject to covenant requirements. The Company believes that its cash flows from operating activities and funds available under its credit facility will be sufficient to fund its growth and anticipated capital requirements for the next twelve months.

The Company is currently in the process of renewing its credit facility. The Company has a commitment from its bank to extend repayment of \$15.0 million to January 1, 2004 if a new credit facility is not in place by that date.

Item 3.

Quantitative And Qualitative Disclosures About Market Risk

The Company's outstanding balance under its \$45.0 million revolving credit facility was approximately \$14.0 million and \$15.5 million as of March 31, 2003 and December 31, 2002, respectively. The credit facility's interest rate varies between 225 and 275 basis points over LIBOR (1.306% as of March 31, 2003), depending on the Company's leverage. The Company is subject to changes in its interest expense on this facility based on fluctuations in interest rates. Assuming an outstanding balance on this credit facility of \$15 million, if the LIBOR were to increase (decrease) by 100 basis points, the Company's interest payments would increase (decrease) by \$37,500 per quarter.

The Company's bonds that financed two of its facilities accrue interest at a rate that approximates LIBOR. The Company is subject to changes in its interest expense on these bonds based on fluctuations in interest rates. Assuming an outstanding balance of these bonds of \$9.7 million, if the LIBOR were to increase (decrease) by 100 basis points, the Company's interest payments would increase (decrease) by \$24,250 per quarter.

The Company does not have any other material market risk sensitive instruments.

Certain Considerations

This report, other documents that are publicly disseminated by the Company, and oral statements that are made on behalf of the Company contain or might contain both statements of historical fact and forward-looking statements. Examples of forward-looking statements include: (a) projections of revenue, earnings, capital structure, and other financial items, (b) statements of the plans and objectives of the Company and its management, (c) statements of future economic performance, and (d) assumptions underlying statements regarding the Company or its business. The cautionary statements set forth below discuss important factors that could cause actual results to differ materially from any forward-looking statements. The Company assumes no obligation to update these forward-looking statements.

Sales Process and Market Acceptance of Products and Services. The Company's future performance depends on its ability to increase revenues to new and existing customers. The Company's sales process for new customers is typically between six and eighteen months in duration from initial contact to purchase commitment. The extended sales process is typically due to the complicated approval process within hospitals for purchases from new suppliers, the long duration of existing supply contracts, and implementation delays pending termination of a hospital's previous supply relationships. The long sales process inhibits the ability of the Company to quickly increase revenues from new and existing customers or enter new markets. The Company's future performance will also depend on market acceptance of its combination of reusable surgical products, disposable accessory packs, and direct delivery and retrieval service.

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Need for Capital. The Company's business is capital intensive and will require substantial capital expenditures for additional surgical products and equipment during the next several years to achieve its operating and expansion plans. To adequately service a new customer, the Company typically makes an investment in new reusable surgical products and carts of approximately 40% of the projected new annual revenue from the customer. The Company's inability to obtain adequate capital could have a material adverse effect on the Company. See Liquidity and Capital Resources.

New Product Offering; Dependence on a Supplier. The Company is regularly developing new instrument processing programs. The Company is subject to a risk that the market will not broadly accept them. Further, the Company relies on Aesculap, Inc. as its major source of supply of instruments for its Instrument Express program. The Joint Marketing Agreement between the Company and Aesculap provides for Aesculap to furnish instruments to the Company until 2013, subject to terms and conditions stated in the agreement. Any failure of Aesculap to furnish instruments for any reason would materially and adversely affect the Company's ability to service this program until the Company secured one or more alternative suppliers.

Dependence on Significant Customers and Market Consolidation. During the three months ended March 31, 2003, Novation, HPG, and Premier, Inc. hospitals accounted for approximately 35%, 15%, and 10% of the Company's sales, compared to 33%, 14%, and 10% in the three months ended March 31, 2002, respectively. Although each Novation, HPG, and Premier hospital currently makes its purchasing decisions on an individual basis, and no single hospital accounted for more than 7% of the Company's sales, the loss of a substantial portion of the Novation, HPG, or Premier hospitals' business would have a material adverse effect on the Company.

Competition. The Company's business is highly competitive. Competitors include a number of distributors and manufacturers, as well as the in-house reprocessing operations of hospitals. Certain of the Company's existing and potential competitors possess substantially greater resources than the Company. Some of the Company's competitors, including Allegiance Corporation (a subsidiary of Cardinal Health, Inc.) and Medline Industries, Inc., serve as the sole supplier of a wide assortment of products to a significant number of hospitals. While the Company has a substantial array of surgical products, many of its competitors have a greater number of products for the entire hospital, which in some instances is a competitive disadvantage for the Company. There is no assurance that the Company will be able to compete effectively with existing or potential competitors.

Pending SEC Investigation. As previously disclosed, the Company is cooperating with a pending investigation by the Securities and Exchange Commission (SEC), which is primarily focused on the Company's accounting for transactions underlying its restatement of its financial results for the third quarter of 2001. Although SRI has reached preliminary agreement with the SEC's staff regarding a settlement with respect to its investigation, this settlement remains subject to documentation and Commission authorization. Further, the settlement covers only SRI and the named individuals. See Legal Proceedings.

Government Regulation. Significant aspects of the Company's businesses are subject to state and federal statutes and regulations governing, among other things, medical waste-disposal and workplace health and safety. In addition, most of the products furnished or sold by the Company are subject to regulation as medical devices by the U.S. Food and Drug Administration (FDA), as well as by other federal and state agencies. The Company's facilities are subject to quality systems inspections by FDA officials. The FDA has the power to enjoin future violations, seize adulterated or misbranded devices, require the manufacturer to remove products from the market, and publicize relevant facts. Federal or state governments might impose additional restrictions or adopt interpretations of existing laws that could materially adversely affect the Company.

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Item 4.

Disclosure Controls and Procedures

Evaluation of Disclosure Controls and Procedures. Within the 90-day period prior to the date of this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company required to be included in the Company's filings with the SEC.

Changes in Internal Controls. There have been no significant changes in the Company's internal controls or in other factors which could significantly affect internal controls subsequent to the date the Company carried out its evaluation.

Limitations on the Effectiveness of Controls. Any system of disclosure controls and internal controls is inherently limited in detecting and preventing all error and all fraud. Even a well conceived control system provides reasonable, not absolute, assurance that its objectives are met and any control system design reflects the company's resource constraints. Persons' judgments in their decision-making can be faulty; breakdowns can occur because of their simple errors or mistakes. Persons can circumvent controls individually or in with other people. There can be no assurance that any design of controls will succeed in achieving its stated goals under all potential conditions.

CEO and CFO Certifications. Certifications of SRI's Chief Executive Officer and Chief Financial Officer appear immediately following the Signatures section of this report, which are required by Section 302 of the Sarbanes-Oxley Act of 2002 (the Section 302 Certifications). This Item of this report is the information concerning the evaluation of disclosure controls referenced in the Section 302 Certifications; the Section 302 Certifications should be read in conjunction with this Item for a more complete understanding of the topics presented.

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PART II OTHER INFORMATION

Item 1.

Legal Proceedings

Class Action Litigation. As previously disclosed, the Company has entered into a Memorandum of Understanding for the settlement and release of claims that were asserted in a Consolidated Amended Class Action Complaint filed on June 4, 2002, in the United States District Court for the Middle District of Florida. This litigation is a consolidation of substantially similar shareholders lawsuits filed against the Company and certain of its former officers beginning on November 30, 2001, following its restatement of its financial results for the 2001 third quarter. The settlement remains subject to court approval. No accruals for damages were recorded by the Company for this matter as of March 31, 2003.

SEC Investigation. The Company is cooperating with a previously disclosed investigation by the Securities and Exchange Commission that is focused primarily on the Company's accounting transactions underlying a restatement of its financial results for the third quarter of 2001. SRI announced the restatement on November 27, 2001, shortly after it initially reported the results on October 25, 2001.

As previously disclosed, the Company has preliminarily agreed with staff of the Securities and Exchange Commission to a settlement with respect to the Commission's investigation of the Company. The settlement remains subject to completion of settlement documentation and Commission authorization.

Item 2.

Changes in Securities

None.

Item 3.

Defaults Upon Senior Securities

None.

Item 4.

Submission of Matters to a Vote of Security Holders

None

Item 5.

Other Information

None.

Item 6.

Exhibits and Reports on Form 8-K

Exhibit

Number

Exhibit Description

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10.54 Joint Marketing Agreement dated as of March 1, 2003 between Aesculap, Inc. and the Company.

Reports on Form 8-K

On January 27, 2003, the Company filed a report on Form 8-K announcing a Memorandum of Understanding for the settlement and release of all claims against the Company and certain former officers in a Consolidated Amended Class Action Complaint.

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Signatures and Certifications of the Chief Executive Officer and the Chief Financial Officer of the Company.

The following pages include the Signatures page for this Form 10-Q and two separate Certifications of the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of the Company.

The first form of Certification is required by Rule 13a-14 under the Securities Exchange Act of 1934 (the Exchange Act) in accord with Section 302 of the Sarbanes-Oxley Act of 2002 (the Section 302 Certification). The Section 302 Certification includes references to an evaluation of the effectiveness of the design and operation of the company's disclosure controls and procedures and its internal controls and procedures for financial reporting. Item 4 of Part I of this Quarterly Report presents the conclusions of the CEO and the CFO about the effectiveness of such controls based on and as of the date of such evaluation (relating to Item 4 of the Section 302 Certification), and contains additional information concerning disclosures to the Company's Audit Committee and independent auditors with regard to deficiencies in internal controls and fraud (Item 5 of the Section 302 Certification) and related matters (Item 6 of the Section 302 Certification).

The second form of Certification is required by section 1350 of chapter 63 of title 18 of the United States Code.

SIGNATURE

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

SRI/SURGICAL EXPRESS, INC.

Date: May 13, 2003

By: /s/ CHARLES L. POPE

Chief Financial Officer

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CERTIFICATIONS

I, Joseph A. Largey, certify that:

1.

I have reviewed this quarterly report on Form 10-Q of SRI/Surgical Express, Inc.;

2.

Based on my knowledge, this quarterly report does not contain any untrue statements of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3.

Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this quarterly report;

4.

The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the Company and have:

a)

designed such disclosure controls and procedures to ensure that material information relating to the Company is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b)

evaluated the effectiveness of the Company's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

c)

presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5.

The Company's other certifying officer and I have disclosed, based on our most recent evaluation, to the Company's auditors and the audit committee of Company's board of directors (or persons performing the equivalent functions):

a)

all significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize and report financial data and have identified for the Company's auditors any material weaknesses in internal controls; and

b)

any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal controls; and

6.

The Company's other certifying officer and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 13, 2003

/s/ JOSEPH A. LARGEY

Joseph A. Largey
Chief Executive Officer

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CERTIFICATIONS (continued)

I, Charles L. Pope, certify that:

1.

I have reviewed this quarterly report on Form 10-Q of SRI/Surgical Express, Inc.;

2.

Based on my knowledge, this quarterly report does not contain any untrue statements of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3.

Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this quarterly report;

4.

The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the Company and have:

a)

designed such disclosure controls and procedures to ensure that material information relating to the Company is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b)

evaluated the effectiveness of the Company's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date); and

c)

presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5.

The Company's other certifying officer and I have disclosed, based on our most recent evaluation, to the Company's auditors and the audit committee of Company's board of directors (or persons performing the equivalent functions):

a)

all significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize and report financial data and have identified for the Company's auditors any material weaknesses in internal controls; and

b)

any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal controls; and

6.

The Company's other certifying officer and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 13, 2003

/s/ CHARLES L. POPE

Charles L. Pope
Chief Financial Officer

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CERTIFICATIONS (continued)

Each of the undersigned hereby certifies, for the purposes of section 1350 of chapter 63 of title 18 of the United States Code, in his capacity as an officer of SRI/Surgical Express, Inc. (SRI), that, to his knowledge, the Quarterly Report of SRI on Form 10-Q for the period ended March 31, 2003, fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934, and that the information contained in this report fairly presents, in all material respects, the financial condition and results of operation of SRI.

Date: May 13, 2003

By: /s/ JOSEPH A. LARGEY

Joseph A. Largey
Chief Executive Officer

Date: May 13, 2003

By: /s/ CHARLES L. POPE

Charles L. Pope
Chief Financial Officer