BALAKRISHNAN BALU
Form 4
March 09, 2010

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

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Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

(Print or Type Responses)

1. Name and Address of Reporting Person *
BALAKRISHNAN BALU

(Last) (First) (Middle)

5245 HELLYER AVE

(Street)

SAN JOSE, CA 95138

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
POWER INTEGRATIONS INC [POWI]

3. Date of Earliest Transaction (Month/Day/Year)
03/05/2010

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
President and CEO

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	03/05/2010		S		8,384 (1)	D	$ 38.8133 (2)	262,081	I	by Trust
Common Stock								12,959	D	
Common Stock								21,023	I	By Trust Yngst Son (3)
Common Stock								21,023	I	Trust for Eldst Son (3)

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
BALAKRISHNAN BALU 5245 HELLYER AVE SAN JOSE, CA 95138			President and CEO	

Signatures

By: /s/ Bill Roeschlein Attorney-In-Fact For: Balu Balakrishnan	03/09/2010
**Signature of Reporting Person	Date

Explanation of Responses:

***** If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

****** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Includes 594 shares acquired under the POWI stock purchase plan on January 29, 1999; 2186 shares acquired under the POWI stock purchase plan on July 30, 1999; 1363 shares acquired under the POWI stock purchase plan on January 31, 2000; 377 shares acquired under the POWI stock purchase plan on July 31, 2000; 208 shares acquired under the POWI stock purchase plan on January 31, 2001; 1154 shares acquired under the POWI stock purchase plan on July 31, 2001; 1267 shares acquired under the POWI stock purchase plan on January 31, 2002; 95 shares acquired under the POWI stock purchase plan on July 31, 2002 and 1140 shares acquired under the POWI stock purchase plan on January 31, 2003.

(2) The range of prices for the enclosed transactions were $38.75 to $38.95. Upon request by the SEC staff, the issuer, or any security holder of the issuer we will provide full information regarding the number of shares sold at each separate price.

(3)

The Reporting Person disclaims beneficial ownership of the shares held by the trust except to the extent of his pecuniary interest therein, and this report should not be deemed an admission that the Reporting Person is the beneficial owner of the trust's shares for purposes of Section 16 or for any other purpose.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. New Roman" SIZE="2">304,000

4,760,000

Instruments

405,000

670,000

1,204,000

1,874,000

Other revenues

1,000

64,000

974,000

188,000

$6,004,000

$7,455,000

$22,134,000

$25,311,000

Other revenues for the nine months ended September 30, 2001 consist primarily of deferred license fee revenues that were recognized in conjunction with the assignment of a distribution agreement (Note 2).

The following are revenues and long-lived assets information by geographic area:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	2000	2001	2000
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Revenues:				
United States	$4,267,000	$5,063,000	$15,870,000	$18,481,000
France	626,000	1,229,000	1,756,000	3,354,000
Other foreign countries	1,111,000	1,163,000	4,508,000	3,476,000
	$6,004,000	$7,455,000	$22,134,000	$25,311,000

	September 30, 2001	December 31, 2000
	(unaudited)	(audited)
Long-lived assets:		
United States	$12,348,000	$12,921,000
France	4,845,000	5,337,000
	$17,193,000	$18,258,000

There were no sales to any one customer that totalled 10% or more of total revenues for the three and nine months ended September 30, 2001, respectively. During the three months ended September 30, 2000, sales to one customer totalled 11% of total revenues. There were no sales to any one customer that totalled 10% or more of total revenues during the nine months ended September 30, 2000.

Note 7 Contingency:

On August 3, 2001, MTrade Comercio Importacao E Exporta, a Brazilian corporation, (MTrade) filed a lawsuit against the Company alleging a breach of contract related to a distribution agreement for certain of the Company s products which the Company terminated due to MTrade s lack of performance under the agreement. The lawsuit seeks unspecified damages, plus court costs and attorney fees. The Company plans to vigorously defend itself against the lawsuit, and is in the process of preparing its response to the complaint.

Note 8 New Accounting Pronouncements:

In July 2001, the Financial Accounting Standards Board (FASB) issued FASB Statements Nos. 141 and 142 (FAS 141 and FAS 142), Business Combinations and Goodwill and Other Intangible Assets . FAS 141 replaces APB 16 and eliminates pooling-of-interests accounting prospectively. It also provides guidance on purchase accounting related to the recognition of intangible assets and accounting for negative goodwill. FAS 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Under FAS 142, goodwill will be tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. FAS 141 and FAS 142 are effective for all business combinations completed after June 30, 2001. Upon adoption of FAS 142, amortization of goodwill recorded for business combinations consummated prior to July 1, 2001 will cease, and intangible assets acquired prior to July 1, 2001 that do not meet the criteria for recognition under FAS 141 will be reclassified to goodwill. Companies are required to adopt FAS 142 for fiscal years beginning after December 15, 2001, but early adoption is permitted. The Company will adopt FAS 142 on January 1, 2002. In connection with the adoption of FAS 142, the Company will be required to perform a transitional goodwill impairment assessment. The Company has not yet determined the impact these standards will have on its results of operations and financial position, and it believes that any impact will be material.

On October 3, 2001, the FASB issued Statement of Accounting Standards No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144). FAS 144 supercedes FAS 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. FAS 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30 (APB 30), Reporting Results of Operations Reporting the Effects of Disposal of a Segment of a Business . FAS 144 develops one accounting model for long-lived assets that are to be disposed of by sale. FAS 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, FAS 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. FAS 144 is effective for the Company for fiscal years beginning after December 15, 2001.

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

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

Results of Operations

Our net sales for the third quarter of 2001 decreased by $1,388,000 or 19% from the third quarter of 2000. The decrease reflects a decrease in our sales of vaccine products of $1,229,000, an increase in our diagnostic product sales of $106,000 and a decrease in our instrument product sales of $265,000. The decrease in our vaccine sales is due solely to Intervet, Inc. s (Intervet) inability to supply us with feline leukemia virus (FeLV) vaccine and our resulting decision on June 1, 2001 to exit the vaccine business. Our increase in diagnostic sales is due to an increase in sales of our canine heartworm diagnostic products of $536,000 offset by a decrease in our sales of poultry diagnostic products of $334,000 and an increase in performance rebates earned by distributors during the third quarter of 2001 of $96,000. The increased sales of our canine heartworm diagnostic products is due to increased sales by our distributors, resulting from our working more closely with them and utilizing unique and aggressive promotional programs such as the WITNESS® Challenge. The decrease in our sales of poultry diagnostic products is due to manufacturing problems at our supplier, which resulted in a June 2001 recall of substantially all of our poultry diagnostics. Our instrument product sales decreased primarily due to our decision in the fourth quarter of 2000 to scale back our instrument manufacturing operations.

Our net sales for the nine months ended September 30, 2001 decreased by $3,963,000 or 16% from the nine months ended September 30, 2000. The decrease reflects a decrease in our sales of vaccine products of $4,456,000, an increase in our diagnostic product sales of $1,163,000 and a decrease in our instrument product sales of $670,000. The decrease in our vaccine sales is due solely to Intervet s inability to supply us with FeLV vaccine and our resulting decision on June 1, 2001 to exit the vaccine business. Our increase in diagnostic sales is due to an increase in sales of our canine heartworm diagnostic products of $1,527,000 and an increase in our sales of poultry diagnostic products of $399,000, which we acquired in April 2000, offset by an increase in performance rebates earned by distributors during 2001 of $763,000. The increased sales of our canine heartworm diagnostic products are due to increased sales by our distributors, resulting from our working more closely with them and utilizing unique and aggressive promotional programs such as the WITNESS® Challenge. The increase in our sales of poultry diagnostic products was a result of having nine months of sales in 2001 compared to less than six months in 2000, but 2001 sales were hurt by manufacturing problems at our supplier, which resulted in a June 2001 recall of substantially all of our poultry diagnostic products. Our instrument product sales decreased primarily due to our decision in the fourth quarter of 2000 to scale back our instrument manufacturing operations.

On June 1, 2001, we assigned our FeLV vaccine distribution agreement with Intervet to Merial Limited, Merial S.A.S. and Merial, Inc. (collectively Merial). In exchange, Merial waived its right to sell back to us 621,000 shares of our common stock at $5.00 per share (the Put Right). Merial also agreed to allow us to pay accrued royalties totalling $613,000 under a separate agreement ($175,000 of which was due in May 2001 and the remainder or which was due in October 2001) in ten monthly installments of $61,300 which began in July 2001. If we fail to meet this royalty payment obligation, the Put Right will revert to Merial. When the final royalty payment has been made in April 2002, and the Put Right is extinguished, we will reclassify the mandatorily redeemable common stock to equity.

In March 1999, we amended our U.S. FeLV vaccine supply agreement with Merial, and we received $1,453,000 which we were recognizing as license fee revenue over the remaining life of the supply agreement. Because we assigned our distribution agreement with

Intervet to Merial, we have no further contractual obligations under the supply agreement and we recognized, in June 2001, the remaining $868,000 of deferred license fee revenue. Our vaccine sales totalled $4,968,000 and $6,013,000 during 2000 and 1999, respectively.

Our cost of sales as a percentage of our net sales was 42% during the third quarter of 2001 compared to 51% during the third quarter of 2000 (i.e., our gross margin increased to 58% from 49%), and our cost of sales as a percentage of our net sales was 42% during the nine months ended September 30, 2001 compared to 50% during the nine months ended September 30, 2000 (i.e., our gross margin increased to 58% from 50%). The higher gross margins are a direct result of these factors:

the decreased vaccine sales which have historically had low margins;

sales of the newly acquired poultry diagnostic products which have significantly higher margins; and

an offset due to the fact that a significant portion of our manufacturing costs are fixed costs.

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

We are currently in the process of transferring the manufacturing of our poultry diagnostic products from our supplier to our manufacturing facilities in San Diego, some of which have already been successfully transferred, and we expect the transfer to be completed by the end of the first quarter of 2002. We believe that our gross margins on these products will improve as we will have more products to absorb our fixed manufacturing costs.

Our research and development expenses during the third quarter of 2001 decreased by $50,000 or 9% from the third quarter of 2000, and decreased by $229,000 or 14% during the nine months ended September 30, 2001 as compared to the nine months ended September 30, 2000. The decreases are due primarily to the decrease in our instrument research and development effort in conjunction with the scaling back of our instrument manufacturing operations, and decreases in patent legal expenses commensurate with reduced patent filing activities. Our research and development expenses as a percentage of our net sales were 8% and 7% during the third quarter of 2001 and 2000, respectively and were 7% and 6% during the nine months ended September 30, 2001 and 2000, respectively.

Our selling and marketing expenses during the third quarter of 2001 decreased by $945,000 or 38% from the third quarter of 2000, and decreased by $2,977,000 or 39% during the nine months ended September 30, 2001 as compared to the nine months ended September 30, 2000. The decreases are due primarily to the disposition of W3COMMERCE (our Internet marketing services subsidiary) during the fourth quarter of 2000, the termination of our direct-to-veterinarian telemarketing group during the third quarter of 2000 and a concerted effort to reduce our print media advertising. Our selling and marketing expenses as a percentage of our net sales were 26% and 34% during the third quarter of 2001 and 2000, respectively, and were 22% and 30% during the nine months ended September 30, 2001 and 2000, respectively.

Our general and administrative expenses during the third quarter of 2001 increased by $62,000 or 4% over the third quarter of 2000, and decreased by $437,000 or 9% during the nine months ended September 30, 2001 as compared to the nine months ended September 30, 2000. The increase during the third quarter is due to consulting expenses, offset by the decrease in our administrative expenses related to our instrument manufacturing operations as a result of the scale back of those operations, a decrease in legal expenses related to a decrease in the level of activity of our patent litigation with Heska Corporation (Heska) and a decrease in

foreign currency transaction losses related to our intercompany balance with Synbiotics Europe (SBIO-E) as that balance has been decreasing. The decrease during the nine month period is due to the decrease in our administrative expenses related to our instrument manufacturing operations as a result of the scale back of those operations, a decrease in legal expenses related to a decrease in the level of activity of our patent litigation with Heska and a decrease in foreign currency transaction losses related to our intercompany balance with SBIO-E as that balance has been decreasing. Our general and administrative expenses as a percentage of our net sales were 25% and 20% during the third quarter of 2001 and 2000, respectively, and were 22% and 20% during the nine months ended September 30, 2001 and 2000, respectively.

Our net interest expense during the third quarter of 2001 decreased by $91,000 or 30% from the third quarter of 2000, and decreased by $169,000 or 19% during the nine months ended September 30, 2001 as compared to the nine months ended September 30, 2000, due to decreases in the prime rate during the first, second and third quarters of 2001, as well as the fact that our $2,813,000 convertible note payable to W3COMMERCE was extinguished on January 1, 2001 in conjunction with our sale of 84% of our investment in W3COMMERCE.

Our effective tax rate was 1% and -2% for the nine months ended September 30, 2001 and 2000, respectively. As of December 31, 2000, we had established a deferred tax asset valuation allowance for all of our U.S. deferred tax assets. During the nine months ended September 30, 2001, we utilized certain U.S. deferred tax assets (primarily net operating loss carryforwards) and we released a corresponding portion of our deferred tax valuation allowance, resulting in no deferred tax expense. In addition, due to our utilization of net operating loss carryforwards, our current tax expense represents alternative minimum taxes.

In July 2001, the Financial Accounting Standards Board (FASB) issued FASB Statements Nos. 141 and 142 (FAS 141 and FAS 142), Business Combinations and Goodwill and Other Intangible Assets . FAS 141 replaces APB 16 and eliminates pooling-of-interests accounting prospectively. It also provides guidance on purchase accounting related to the recognition of intangible assets and accounting for negative goodwill. FAS 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Under FAS 142, goodwill will be tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. FAS 141 and FAS 142 are effective for all business combinations completed after June 30, 2001. Upon adoption of FAS 142, amortization of goodwill recorded for business combinations consummated prior to July 1, 2001 will cease, and intangible assets acquired prior to July 1, 2001 that do not meet the criteria for recognition under FAS 141 will be reclassified to goodwill. Companies are required to adopt FAS 142 for fiscal years beginning after December 15, 2001, but early adoption is permitted. We will adopt FAS 142 on January 1, 2002. In connection with the adoption of FAS 142, we will be required to perform a transitional goodwill impairment assessment. We have not yet determined the impact these standards will have on our results of operations and financial position.

On October 3, 2001, the FASB issued Statement of Accounting Standards No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144). FAS 144 supercedes FAS 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. FAS 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30 (APB 30), Reporting Results of Operations Reporting the Effects of Disposal of a Segment of a Business . FAS 144 develops one accounting model for long-lived assets that are to be disposed of by sale. FAS 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, FAS 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. FAS 144 is effective for us for fiscal years beginning after December 15, 2001.

Financial Condition and Liquidity

We believe that our present capital resources, which included negative working capital of $2,836,000 at September 30, 2001, are insufficient to meet our working capital needs and service our debt for the next twelve months. Additionally, pursuant to our debt agreement with Imperial Bank, we are required to maintain certain financial ratios and levels of tangible net worth and we are also restricted in our ability to make capital expenditures or investments without Imperial Bank s consent. As of September 30, 2001, we had outstanding principal balances on our Imperial Bank debt of $7,532,000. As of September 30, 2001, we were not in compliance with some of our financial covenants, and we had not obtained a waiver from Imperial Bank. In any event, the debt matures on March 29, 2002. We do not have enough capital resources to repay the debt.

It is imperative that we raise additional capital within the next few months. We are currently exploring our options which potentially include the sale of our business, a merger or acquisition, debt restructuring, and the sale of additional equity. In addition, we have taken steps to eliminate cash drains; for example, in the fourth quarter of 2000 we divested W3COMMERCE and scaled back our instrument manufacturing operations, and we terminated our direct selling initiative in the third quarter of 2000.

We restructured a $1,000,000 payment due to Kirkegaard & Perry Laboratories, Inc. (KPL) in conjunction with our April 2000 acquisition of KPL s poultry diagnostic product line by agreeing to pay $200,000 in April 2001 and to make eight monthly payments of $100,000 beginning in May 2001. As of September 30, 2001, we had a remaining balance of $300,000.

Additionally, the 621,000 shares of our common stock which we issued to Merial in conjunction with the 1997 acquisition of SBIO-E were subject to a put provision which gave Merial the right, beginning on July 9, 2001, to sell all or any portion of its shares to us at a price of $5 per share, for a total of $3,107,000. In June 2001, in conjunction with the assignment to Merial of our FeLV vaccine distribution rights, Merial waived its rights under the put provision. However, if we fail to make certain royalty payments to Merial between July 2001 and April 2002, the rights under the put provision will revert to Merial and we would not have the funds necessary to buy back the shares.

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

Future Operating Results

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

It is imperative that we obtain additional capital in the near future

We will need to raise additional capital within the next few months or else we will be unable to build sufficient inventory in anticipation of next year s canine heartworm diagnostic selling season. We are currently exploring our options which potentially include the sale of our business, a merger or acquisition, debt restructuring, and the sale of additional equity.

As of September 30, 2001, we were not in compliance with covenants on $7,532,000 of indebtedness to Imperial Bank (see below). If Imperial Bank declares the loans to be in default, we will be unable to repay the loans. Also, we do not have the resources to repay the loans on their March 29, 2002 maturity date.

Additionally, the 621,000 shares of our common stock which we issued to Merial in conjunction with the 1997 acquisition of SBIO-E were subject to a put provision which gave Merial the right, beginning on July 9,

2001, to sell all or any portion of its shares to us at a price of $5 per share, for a total of $3,107,000. In June 2001, in conjunction with the assignment to Merial of our feline leukemia vaccine distribution rights, Merial waived its rights under the put provision. However, if we fail to make certain royalty payments to Merial between July 2001 and April 2002, the rights under the put provision will revert to Merial and we would not have the funds necessary to buy back the shares.

Our independent auditors report, related to our financial statements as of and for the year ended December 31, 2000, indicated that they have substantial doubt about our ability to continue as a going concern.

We are not in compliance with our bank loan covenants

As of September 30, 2001, we were not in compliance with some of the financial covenants in our agreement with Imperial Bank, and we have not obtained waivers from the bank. We cannot assure you that we will be in compliance with the covenants in the future. Failure to be in compliance with the covenants places us in technical default of the debt agreement, and Imperial could demand repayment of the loans. We do not have and would not have the funds to repay the loans on short notice.

We may sell our business

In 2000, we announced that we engaged investment bankers to consider means of enhancing shareholder value, including the possible sale of our business. There can be no assurance that our business can be sold for a favorable price. Also, the uncertainties caused by this process may undermine our relationships with our customers, employees and suppliers.

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

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

Our canine heartworm diagnostic products constituted 44% of our sales for the nine months ended September 30, 2001. In addition to our historic competition with IDEXX Laboratories, the sales leader in this product category, our sales were substantially affected in 1999 2001 by a new heartworm product from Heska Corporation. We are suing Heska, claiming that its heartworm product infringes our patent.

We have a history of losses and an accumulated deficit

We did not achieve profitability for the years ended December 31, 1998, 1999 and 2000, and we have had a history of annual losses. We have incurred a consolidated accumulated deficit of $30,473,000 at September 30, 2001. We may not achieve annual profitability again and if we are profitable in the future there can be no assurance that profitability can be sustained.

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

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

targeted markets. Distributor agreements render our sales exposed to the efforts of third parties who are not employees of Synbiotics and over whom we have no control. Their failure to generate significant sales of our products could materially harm our business. Reduction by these distributors of the quantity of our products which they distribute would materially harm our business. In addition, IDEXX Laboratories prohibition against its distributors carrying competitors products, including ours, has made, and could continue to make, some distributors unavailable to us. We adopted a similar policy in the second quarter of 1999, which caused some of our distributors to abandon our product line. We have rescinded this policy, and all but one of our former distributors are again selling our products.

Our direct selling strategy has been scaled back

At the end of the third quarter of 2000, we refocused our sales and marketing efforts towards traditional animal health distribution and, as a result, we significantly reduced the headcount of our telesales force. Our 1999 foray toward direct selling to veterinarians, and our subsequent scale-back of that effort, may have created confusion in the market. Some effects of that confusion may persist.

There is no assurance that acquired businesses can be successfully combined

There can be no assurance that the anticipated benefits of the April 2000 acquisition of the poultry product line from KPL, or any other future acquisitions (collectively, the Acquired Business) will be realized. Acquisitions of businesses involve numerous risks, including difficulties in the assimilation of the operations, technologies and products of the Acquired Business, introduction of different distribution channels, potentially dilutive issuances of equity and/or increases in leverage and risk resulting from issuances of debt securities, the need to establish internally operating functions which had been previously provided pre-acquisition by a corporate parent, accounting charges, operating companies in different geographic locations with different cultures, the potential loss of key employees of the Acquired Business, the diversion of management s attention from other business concerns and the risks of entering markets in which we have no or limited direct prior experience. In addition, there can be no assurance that the acquisitions will not have a material adverse effect upon our business, results of operations, financial condition or cash flows, particularly in the quarters immediately following the consummation of the acquisition, due to operational disruptions, unexpected expenses and accounting charges which may be associated with the integration of the Acquired Business and us, as well as operating and development expenses inherent in the Acquired Business itself as opposed to integration of the Acquired Business. We did not achieve the hoped-for benefits from some of our past acquisitions, such as W3COMMERCE (2000) and Prisma (1998).

We depend on key executives and personnel

Our future success will depend, to a significant extent, on the ability of our management to operate effectively, both individually and as a group. Competition for qualified personnel in the animal health care products industry is intense, and we may not be successful in attracting and retaining such personnel. There are only a limited number of persons with the requisite skills to serve in those positions and it may become increasingly difficult to hire such persons. The loss of the services of any of our key personnel or the inability to attract or retain qualified personnel could harm our business.

We depend on third party manufacturers

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

reduced control over delivery schedules;

quality assurance;

manufacturing yields and costs;

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

limited warranties on products supplied to us;

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

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

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

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

In June 2001, KPL instituted a recall of substantially all of our poultry diagnostic products that were manufactured by KPL due to a defective conjugate contained in the products. We have replaced the affected products that were held by our customers. The cost of this recall and the related replacement products was borne by KPL. However, our sales of poultry diagnostic products during the third quarter of 2001 were adversely affected, and our future sales of these products could be materially adversely affected.

We rely on new and recent products

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

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

Our canine heartworm business is seasonal

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

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

We rely on a combination of patent, copyright, and trademark laws, trade secrets, and confidentiality and other contractual provisions to protect our proprietary rights. These measures afford only limited protection. We currently have 13 issued U.S. patents and one pending patent application. Our means of protecting our proprietary rights in the U.S. or abroad may not be adequate and competitors may independently develop similar technologies. Our future success will depend in part on our ability to protect our proprietary rights and the technologies used in our principal products. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use trade secrets or other information that we

regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. Issued patents may not preserve our proprietary position. Even if they do, competitors or others may develop technologies similar to or superior to our own. If we do not enforce and protect our intellectual property, our business will be harmed. From time to time, third parties, including our competitors, have asserted patent, copyright, and other intellectual property rights to technologies that are important to us. We expect that we will increasingly be subject to infringement claims as the number of products and competitors in the animal health care market increases.

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

pay substantial damages, including treble damages if we are held to have willfully infringed;

cease the manufacture, use and sale of infringing products;

expend significant resources to develop non-infringing technology; or

obtain licenses to the infringing technology.

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

Also, litigation is costly regardless of its outcome and can require significant management attention. For example, in 1997, Barnes-Jewish Hospital filed an action against us claiming that our canine heartworm diagnostic products infringe their patent. We settled this lawsuit, but there can be no assurance that we would be able to resolve similar incidents in the future. Our patent infringement litigation against Heska s use of heartworm diagnostic technology is also expensive.

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

the patent coverage which we receive could be significantly narrower than the patent coverage we seek in our patent applications; and

our patent positions involve complex legal and factual issues which can be hard for patent examiners or lawyers asserting patent coverage to successfully resolve.

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

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

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

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

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

We use hazardous materials

Our business requires that we store and use hazardous materials and chemicals. Although we believe that our procedures for storing, handling, and disposing of these materials comply with the standards prescribed by local, state, and federal regulations, the risk of accidental contamination or injury from these materials cannot be completely eliminated. If any of these materials were mishandled, or if an accident with them occurred, the consequences could be extremely damaging and we could be held liable for them. Our liability for such an event would materially harm our business and could exceed all of our available resources for satisfying it.

Item 3 Quantitative and Qualitative Disclosures About Market Risk

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

Interest Rate Risk

The fair value of our interest bearing debt at September 30, 2001 was $7,532,000, which has a variable interest rate based on the prime rate.

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

Foreign Currency Exchange Rate Risk

Our foreign currency exchange rate risk relates to the operations of SBIO-E as it transacts business in Euros, its local currency. However, this risk is limited to our intercompany receivable from SBIO-E and the conversion of its financial statements into the U.S. dollar for consolidation. There is no foreign currency exchange rate risk related to SBIO-E s transactions outside of the European Union as those transactions are denominated in Euros. Similarly, all of the foreign transactions of our U.S. operations are denominated in U.S. dollars. We do not hedge our cash flows on intercompany transactions, nor do we hold any other derivative securities or hedging instruments based on currency

exchange rates. As a result, the effects of a 5% change in exchange rates would have a material impact on our financial condition, results of operations and cash flows, but only to the extent that it relates to the conversion of SBIO-E s financial statements, including its intercompany payable, into the U.S. dollar for consolidation.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

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

On November 12, 1998, we filed a lawsuit against Heska Corporation (Heska) claiming that Heska infringes a patent owned by us, which covers both our and Heska s heartworm diagnostic products. On January 14, 1999, Heska filed a counterclaim against us seeking a declaratory judgment that our patent is invalid and unenforceable. We deny Heska s allegations that our patent is invalid and unenforceable, and plan to vigorously defend our patent against the allegations. In the event that we were to lose our lawsuit against Heska, we believe our only direct liability would be our out-of-pocket legal expenses. Although Heska s counterclaim does not include a claim for damages, if we were to lose on Heska s counterclaim, we could face additional competition for our canine heartworm diagnostic products as other third parties would be able to manufacture products incorporating our patented technology. The lawsuit is scheduled for trial in April 2002.

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

On August 3, 2001, MTrade Comercio Importacao E Exporta, a Brazilian corporation, (MTrade) filed a lawsuit against us alleging a breach of contract related to a distribution agreement for certain of our products which we terminated due to MTrade s lack of performance under the agreement. The lawsuit seeks unspecified damages, plus court costs and attorney fees. We plan to vigorously defend ourselves against the lawsuit, and we are in the process of preparing our response to the complaint.

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

(a) *Exhibits*

None.

(b) *Reports on Form 8-K*

None.

SIGNATURES

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

SYNBIOTICS CORPORATION

Date: November 6, 2001

/s/ Michael K. Green

Michael K. Green
Senior Vice President and Chief Financial Officer
(signing both as a duly authorized officer and as principal financial officer)

Explanation of Responses: