INVERNESS MEDICAL INNOVATIONS INC
Form 10-Q
May 09, 2006

# UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended March 31, 2006**

**OR**

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

**For the transition period from to**

**COMMISSION FILE NUMBER 001-16789**

# INVERNESS MEDICAL INNOVATIONS, INC.

(Exact Name Of Registrant As Specified In Its Charter)

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

**Yes x No o**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o | Accelerated filer x | Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

**Yes o No x**

The number of shares outstanding of the registrant s common stock, par value of $0.001 per share, as of May 5, 2006 was 32,061,875.

**INVERNESS MEDICAL INNOVATIONS, INC.**

**REPORT ON FORM 10-Q**

**For the Quarterly Period Ended March 31, 2006**

*This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Readers can identify these statements by forward-looking words such as may, could, should, would, intend, will, expect, anticipate, believe, estimate, continue or similar words. There are a number of important factors that could cause actual results of Inverness Medical Innovations, Inc. and its subsidiaries to differ materially from those indicated by such forward-looking statements. These factors include, but are not limited to, the risk factors detailed in Part I, Item 1A, Risk Factors, of our Annual Report on Form 10-K for the fiscal year ending December 31, 2005 and other risk factors identified herein or from time to time in our periodic filings with the Securities and Exchange Commission. Readers should carefully review these factors as well as the Special Statement Regarding Forward-Looking Statements beginning on page 34, in this Quarterly Report on Form 10-Q and should not place undue reliance on our forward-looking statements. These forward-looking statements are based on information, plans and estimates at the date of this report. We undertake no obligation to update any forward-looking statements to reflect changes in underlying assumptions or factors, new information, future events or other changes.*

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

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## PART I. FINANCIAL INFORMATION

**PART I FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(unaudited)
(in thousands, except per share amounts)

| | Three Months Ended March 31, | |
|---|---|---|
| | **2006** | **2005** |
| Net product sales | $ 122,753 | $ 89,699 |
| License and royalty revenue | 5,068 | 2,221 |
| **Net revenue** | 127,821 | 91,920 |
| Cost of sales | 75,567 | 59,731 |
| **Gross profit** | 52,254 | 32,189 |
| Operating expenses: | | |
| Research and development (Note 10) | 10,610 | 7,232 |
| Sales and marketing | 20,822 | 17,030 |
| General and administrative | 15,838 | 14,115 |
| Total operating expenses | 47,270 | 38,377 |
| **Operating (loss) income** | 4,984 | (6,188) |
| Interest expense, including amortization of original issue discounts and write-off of deferred financing costs (Note 11) | (5,721) | (5,012) |
| Other income (expense), net | (428) | 4,911 |
| **Loss before provision for income taxes** | (1,165) | (6,289) |
| Provision for income taxes | 1,465 | 1,513 |
| **Net loss** | $ (2,630) | $ (7,802) |
| **Net loss per common share basic and diluted (Note 5)** | $ (0.09) | $ (0.37) |
| **Weighted average common shares basic and diluted (Note 5)** | 29,585 | 20,942 |

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

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS**

(unaudited)
(in thousands, except par value)

| | March 31, 2006 | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| **Current assets:** | | |
| Cash and cash equivalents | $ 33,525 | $ 34,270 |
| Accounts receivable, net of allowances of $9,807 at March 31, 2006 and $9,748 at December 31, 2005 | 88,903 | 70,476 |
| Inventories | 69,506 | 71,209 |
| Deferred tax assets | 845 | 844 |
| Prepaid expenses and other current assets | 18,462 | 17,534 |
| **Total current assets** | 211,241 | 194,333 |
| Property, plant and equipment, net | 75,077 | 72,211 |
| Goodwill | 372,713 | 322,210 |
| Other intangible assets with indefinite lives | 72,326 | 63,742 |
| Core technology and patents, net | 62,469 | 64,050 |
| Other intangible assets, net | 99,622 | 60,489 |
| Deferred financing costs, net and other non-current assets | 11,996 | 13,469 |
| Deferred tax assets | 825 | 662 |
| **Total assets** | $ 906,269 | $ 791,166 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| **Current liabilities:** | | |
| Current portion of long-term debt | $ 1,850 | $ 2,367 |
| Current portion of capital lease obligations | 552 | 542 |
| Accounts payable | 36,491 | 42,155 |
| Accrued expenses and other current liabilities | 78,670 | 64,746 |
| **Total current liabilities** | 117,563 | 109,810 |
| **Long-term liabilities:** | | |
| Long-term debt, net of current portion | 255,630 | 258,617 |
| Capital lease obligations, net of current portion | 834 | 978 |
| Deferred tax liabilities | 19,868 | 18,881 |
| Other long-term liabilities | 5,669 | 5,572 |
| **Total long-term liabilities** | 282,001 | 284,048 |
| **Commitments and contingencies (Note 14)** | | |
| **Series A redeemable convertible preferred stock, $0.001 par value:** | | |
| Authorized: 2,667 shares | | |
| Issued: 2,527 shares at March 31, 2006 and December 31, 2005 | | |
| Outstanding: none at March 31, 2006 and December 31, 2005 | | |
| **Stockholders equity:** | | |
| Preferred stock, $0.001 par value | | |
| Authorized: 2,333 shares | | |
| Issued: none | | |
| Common stock, $0.001 par value | | |
| Authorized: 50,000 shares | | |
| Issued and outstanding: 32,035 at March 31, 2006 and 27,497 shares at December 31, 2005 | 32 | 27 |
| Additional paid-in capital | 624,067 | 515,147 |
| Notes receivable from stockholders | (14,691) | (14,691) |
| Accumulated deficit | (112,857) | (110,227) |
| Accumulated other comprehensive income | 10,154 | 7,052 |
| **Total stockholders equity** | 506,705 | 397,308 |
| **Total liabilities and stockholders equity** | $ 906,269 | $ 791,166 |

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

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**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited)
(in thousands)

| | Three Months Ended March 31, | |
|---|---|---|
| | **2006** | **2005** |
| **Cash Flows from Operating Activities:** | | |
| Net loss | $ (2,630) | $ (7,802) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Interest expense related to amortization and/or write-off of non-cash original issue discount and deferred financing costs | 677 | 443 |
| Depreciation and amortization | 7,646 | 6,202 |
| Non-cash (income) loss related to currency hedge | (217) | 4 |
| Deferred income taxes | 743 | 638 |
| Other non-cash items | 141 | (72) |
| Non-cash stock-based compensation | 1,318 | |
| Minority interest | | 207 |
| Changes in assets and liabilities, net of acquisitions: | | |
| Accounts receivable, net | (6,308) | 8,688 |
| Inventories | 4,413 | (2,997) |
| Prepaid expenses and other current assets | (780) | (4,476) |
| Accounts payable | (7,367) | 5,348 |
| Accrued expenses and other current liabilities | (4,469) | 9,048 |
| Other non-current liabilities | 91 | 76 |
| **Net cash provided by (used in) operating activities** | (6,742) | 15,307 |
| **Cash Flows from Investing Activities:** | | |
| Purchases of property, plant and equipment | (4,349) | (3,979) |
| Proceeds from sale of property, plant and equipment | 33 | 43 |
| Cash paid for acquisitions and transactional costs, net of cash acquired | (70,169) | (15,776) |
| Decrease (increase) in other assets | 1,040 | (394) |
| **Net cash used in investing activities** | (73,445) | (20,106) |
| **Cash Flows from Financing Activities:** | | |
| Cash paid for financing costs | (316) | (355) |
| Proceeds from issuance of common stock, net of issuance costs | 82,128 | 899 |
| Net (repayment) proceeds under revolving line of credit | (3,654) | 22,170 |
| Repayments of notes payable | (42) | (9) |
| Principal payments of capital lease obligations | (137) | (115) |
| **Net cash provided by financing activities** | 77,979 | 22,590 |
| Foreign exchange effect on cash and cash equivalents | 1,463 | (880) |
| **Net (decrease) increase in cash and cash equivalents** | (745) | 16,911 |
| **Cash and cash equivalents, beginning of period** | 34,270 | 16,756 |
| **Cash and cash equivalents, end of period** | $ 33,525 | $ 33,667 |
| **Supplemental Disclosure of Non-cash Activities:** | | |
| Fair value of stock issued for acquisitions | $ 25,480 | $ 57,962 |

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

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(unaudited)

## (1) Basis of Presentation of Financial Information

The accompanying consolidated financial statements of Inverness Medical Innovations, Inc. and its subsidiaries are unaudited. In the opinion of management, the unaudited consolidated financial statements contain all adjustments considered normal and recurring and necessary for their fair presentation. Interim results are not necessarily indicative of results to be expected for the year. These interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, these consolidated financial statements do not include all of the information and footnotes necessary for a complete presentation of financial position, results of operations and cash flows. Our audited consolidated financial statements for the year ended December 31, 2005 included information and footnotes necessary for such presentation and were included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 15, 2006. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements and notes thereto for the year ended December 31, 2005.

## (2) Cash and Cash Equivalents

We consider all highly liquid cash investments with original maturities of three months or less at the date of acquisition to be cash equivalents. At March 31, 2006, our cash equivalents consisted of money market funds.

## (3) Inventories

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

| | March 31, 2006 | December 31, 2005 |
|---|---|---|
| Raw materials | $ 25,562 | $ 25,488 |
| Work-in-process | 16,053 | 17,812 |
| Finished goods | 27,891 | 27,909 |
| | $ 69,506 | $ 71,209 |

## (4) Stock-Based Compensation

Effective January 1, 2006, we began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 123-R, *Share-Based Payment*, as interpreted by SEC Staff Accounting Bulletin No. 107. Prior to January 1, 2006, we accounted for stock options according to the provisions of Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations, and therefore no related compensation expense was recorded for awards granted with no intrinsic value. We adopted the modified prospective transition method provided for under SFAS No. 123-R, and consequently have not retroactively adjusted results from prior periods. Under this transition method, compensation cost associated with stock options now includes: (i) amortization related to the remaining unvested portion of all stock option awards granted prior to January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and (ii) amortization related to all stock option awards granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123-R. In addition, we record expense over the offering period in connection with shares issued under our employee stock purchase plan. The compensation expense for stock-based compensation awards includes an estimate for forfeitures and is recognized over the expected term of the options using the straight-line method.

In accordance with SFAS No. 123-R, as of March 31, 2006, our results of operations reflected compensation expense for new stock options granted and vested under our stock incentive plan and employee stock purchase plan during the first three months of 2006 and the unvested portion of previous stock option grants which vested during the first three months of 2006. Stock-based compensation expense in the amount of $1.3 million (or $1.2 million net of tax effects) was reflected in the consolidated statement of operations for the first three months of 2006 as follows (in thousands):

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| | Three Months Ended March 31, 2006 |
|---|---|
| Cost of sales | $ 109 |
| Research and development | 270 |
| Sales and marketing | 188 |
| General and administrative | 751 |
| | $ 1,318 |

Prior to our adoption of SFAS No. 123-R, we reported all tax benefits resulting from the exercise of stock options as operating cash flows in our consolidated statements of cash flows. In accordance with SFAS No. 123-R, for the three months ended March 31, 2006, the presentation of our cash flows has changed from prior periods to report the excess tax benefits from the exercise of stock options as financing cash flows. For the three months ended March 31, 2006, no excess tax benefits were generated from option exercises.

For stock options granted prior to the adoption of SFAS No. 123-R, if expense for stock-based compensation had been determined under the fair value method for the three months ended March 31, 2005, our net loss and net loss per common share would have been adjusted to the following pro forma amounts (in thousands, except for per share data):

| | Three Months Ended March 31, 2005 |
|---|---|
| Net loss as reported | $ (7,802) |
| Pro forma stock-based employee compensation | (1,586) |
| Net loss pro forma | $ (9,388) |
| Net loss per common share basic and diluted: | |
| Net loss per common share as reported | $ (0.37) |
| Pro forma stock-based employee compensation | (0.07) |
| Net loss per common share pro forma | $ (0.44) |

Our stock option plans provide for grants of options to employees to purchase common stock at the fair market value of such shares on the grant date of the award. The options vest over a four year period, beginning on the date of grant, with a graded vesting schedule of 25% at the end of each of the four years. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing method. We use historical data to estimate the expected price volatility and the expected forfeiture rate. For the three months ended March 31, 2006, we have chosen to employ the simplified method of calculating the expected option term, which averages an award s weighted average vesting period and its contractual term. The contractual term of our stock option awards is ten years. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant with a remaining term equal to the expected term of the option. We have not made any dividend payments nor do we have plans to pay dividends in the foreseeable future. The following assumptions were used to estimate the fair value of options granted during the first three months of 2006 and 2005 using the Black-Scholes option-pricing model:

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| **Stock Options:** | **2006** | | **2005** | |
| Risk-free interest rate | 4.38 | % | 3.58-3.73% | |
| Expected dividend yield | | | | |
| Expected life | 6.25 years | | 5 years | |
| Expected volatility | 42 | % | 46 | % |

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| **Employee Stock Purchase Plan:** | **2006** | | **2005** | |
| Risk-free interest rate | 4.55 | % | 3.71 | % |
| Expected dividend yield | | | | |
| Expected life | 182 days | | 182 days | |
| Expected volatility | 32.71 | % | 46 | % |

A summary of the stock option activity for the three months ended March 31, 2006 is as follows (in thousands, except price per share and contractual term):

| | Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Options outstanding, January 1, 2006 | 3,901,726 | $ 18.82 | | |
| Granted | 100,500 | $ 26.61 | | |
| Exercised | (139,837) | $ 15.04 | | |
| Forfeited or expired | (178,129) | $ 21.01 | | |
| Options outstanding, March 31, 2006 | 3,684,260 | $ 19.07 | 6.8 years | $ 36,041 |
| Options exercisable, March 31, 2006 | 2,416,306 | $ 16.36 | 5.8 years | $ 30,335 |

The weighted average fair value under the Black-Scholes option pricing model of options granted to employees during the three months ended March 31, 2006 and 2005 were $12.89 and $10.60 per share, respectively.

As of March 31, 2006, there were $10.8 million, net of estimated forfeitures, related to unvested stock options that are expected to vest. That cost is expected to be recognized over a weighted-average period of 2.64 years.

## (5) Net Loss Per Common Share

The following table sets forth the computation of basic and diluted net loss per common share (in thousands, except per share amounts):

| | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| **Numerator:** | | |
| Net loss basic and diluted | $ (2,630) | $ (7,802) |
| **Denominator:** | | |
| Weighted average common shares - basic and diluted | 29,585 | 20,942 |
| Net loss per common share basic and diluted | $ (0.09) | $ (0.37) |

We had the following potential dilutive securities outstanding on March 31, 2006: (a) options and warrants to purchase an aggregate of 4.4 million shares of common stock at a weighted average exercise price of $18.71 per share, and (b) 104,000 shares of common stock held in escrow. These potential dilutive securities were not included in the computation of diluted net loss per share because the effect of including such potential dilutive securities would be anti-dilutive.

We had the following potential dilutive securities outstanding on March 31, 2005: (a) options and warrants to purchase an aggregate of 4.3 million shares of common stock at a weighted average exercise price of $16.58 per share, and (b) 104,000 shares of common stock held in escrow. These potential dilutive securities were not included in the computation of diluted net loss per share because the effect of including such potential dilutive securities would be anti-dilutive.

## (6) Comprehensive Income or Loss

We account for comprehensive income as prescribed by SFAS No. 130, *Reporting Comprehensive Income*. In general, comprehensive income (loss) combines net income (loss) and other changes in equity during the year from non-owner sources. Our accumulated other comprehensive income, which is a component of shareholders equity, includes primarily foreign currency translation adjustments and is our only source of equity from non-owners. For the three months ended March 31, 2006 and 2005, we generated a comprehensive income of $0.5 million and a comprehensive loss of $10.3 million, respectively.



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**(7) Stockholders Equity**

On February 8 and 9, 2006, we sold an aggregate 3,400,000 shares of our common stock at $24.41 per share to funds affiliated with 14 accredited institutional investors in a private placement. Proceeds from the private placement were approximately $79.3 million, net of issuance costs of $3.7 million. Of this amount, we repaid principal and interest outstanding under our senior credit facility of $74.1 million, with the remainder of the net proceeds retained for general corporate purposes.

In connection with the February 2006 private placements of common stock, we agreed to use commercially reasonable efforts to register the resale of the private placement shares prior to June 8, 2006. In the event that we are unable to take a registration statement effective prior to June 8, 2006, we will pay an illiquidity discount equal to 1% of the February 2006 offering proceeds per month until the earlier of (i) the date that the registration statement is declared effective or (ii) February 8, 2008.

**(8) Business Combinations**

All of the acquisitions discussed below resulted in the recognition of goodwill. Acquisitions are an important part of our growth strategy. When we acquire businesses, we seek to complement existing products and services, enhance or expand our product lines and/or expand our customer base. We determine what we are willing to pay for each acquisition partially based on our expectation that we can cost effectively integrate the products and services of the acquired companies into our existing infrastructure. In addition, we utilize the existing infrastructure of the acquired companies to cost effectively introduce our products to new geographic areas. All of these factors contributed to the acquisition prices of the acquired businesses discussed below, that were in excess of the fair value of net assets acquired and the resultant goodwill.

*(a) Acquisition of Innovacon*

On March 31, 2006, we acquired the assets of ACON Laboratories business of researching, developing, manufacturing, marketing and selling lateral flow immunoassay and directly-related products in the United States, Canada, Europe (excluding Russia, the former Soviet Republics that are not part of the European Union, Spain, Portugal and Turkey), Israel, Australia, Japan and New Zealand ( Innovacon ). The preliminary aggregate purchase price was approximately $90.2 million which consisted of $55.1 million in cash, 711,676 shares of our common stock with an aggregate fair value of $19.7 million, $5.4 million in estimated direct acquisition costs and an additional liability of $10.0 million payable to the sellers on the deferred payment date, pursuant to the purchase agreement. The fair value of our common stock was determined based on the average market price of our common stock pursuant to Emerging Issue Task Force ( EITF ) Issue No. 99-12, *Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination.* In addition to the amounts described above, we will be required to make additional payments of between $56.1 million to $91.1 million upon the completion of the construction, permitting and validation of a newly constructed manufacturing facility in Hangzhou, China and regulatory clearance in Spain and Portugal. $31.25 million of the remaining payments will be made through the issuance of our common stock, with the balance payable in cash. The timing and amount of any such payments is contingent upon the successful completion of various milestones, as defined in the acquisition agreement, and certain regulatory approvals.

The aggregate purchase price was preliminarily allocated to the assets acquired and liabilities assumed at the date of acquisition as follows (in thousands):

| | |
|---|---|
| Accounts receivable | $ 11,000 |
| Inventories | 2,000 |
| Goodwill | 38,198 |
| Trademarks | 5,000 |
| Customer relationships | 30,000 |
| Supply agreements | 5,000 |
| Accounts payable and accrued expenses | (1,000) |
| | $ 90,198 |

The above values for the assets acquired and liabilities assumed are based on preliminary management estimates due to the timing of the acquisition. Final purchase price allocation may differ from the above. Management is also in the process of determining the useful lives of the core technology and intangible assets, as listed above.

The acquisition of Innovacon is accounted for as a purchase under SFAS No. 141, *Business Combinations*. Accordingly, the operating results of Innovacon will be included in our consolidated financial statements from the acquisition date as part of our consumer and professional diagnostic products reporting units and business segments. Goodwill generated from this acquisition is not deductible for tax purposes.



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*(b) Acquisition of CLONDIAG*

On February 28, 2006, we acquired 67.45% of CLONDIAG chip technologies GmbH ( CLONDIAG ), a private company located in Jena in Germany which has developed a multiplexing technology for nucleic acid and immunoassay-based diagnostics. The acquisition agreement provides that we will purchase the remaining 32.55% on or before August 1, 2006. The aggregate purchase price was $22.7 million, which consisted of $11.8 million in cash, 218,502 shares of our common stock with an aggregate fair value of $5.8 million and a $5.1 million payable to acquire the remaining 32.55% stock ownership. In the event that the value of the shares issued in connection with the acquisition is less than 4.87 million on December 29, 2006, we will be required to pay the sellers additional cash in the amount of the shortfall. The fair value of our common stock issued was determined pursuant to EITF Issue No. 99-12. The terms of the acquisition agreement also provide for contingent consideration totaling approximately $8.9 million, consisting of 224,316 shares of common stock and approximately $3.0 million of cash or stock, in the event that four specified products are developed on CLONDIAG s platform technology during the three years following the acquisition date. This contingent consideration will be accounted for as an increase in the aggregate purchase price, if and when the resolution of the contingency occurs.

The aggregate purchase price was preliminarily allocated to the assets acquired and liabilities assumed at the date of acquisition as follows (in thousands):

| | |
|---|---|
| Cash and cash equivalents | $ 270 |
| Accounts receivable | 588 |
| Inventories | 192 |
| Prepaid expenses | 28 |
| Property, plant and equipment | 1,776 |
| Goodwill | 21,921 |
| Other assets | 21 |
| Accounts payable and accrued expenses | (2,134 ) |
| | $ 22,662 |

The above values for the assets acquired and liabilities assumed are based on preliminary management estimates due to the timing of the acquisition. Final purchase price allocation may differ from the above values and will include an evaluation of whether certain in-process research and development projects have yet reached technical feasibility. The value of projects which have not yet reached technical feasibility, if any, will be expensed as in-process research and development when quantified.

The acquisition of CLONDIAG is accounted for as a purchase under SFAS No. 141. Accordingly, the operating results of CLONDIAG, which consist principally of research and development activities, have been included in the accompanying consolidated financial statements since the acquisition date as part of our corporate and other business segment. Goodwill generated from this acquisition is not deductible for tax purposes.

*(c) Pro Forma Financial Information*

The following table presents selected unaudited financial information of our company, including Binax, Inc. ( Binax ), Ischemia Technologies, Inc. ( Ischemia ), the Determine/DainaScreen assets of Abbott Laboratories rapid diagnostic business (the Determine business ), Thermo BioStar, Inc. ( BioStar ), Innogenetics Diagnostica Y Terapeutica, S.A.U. ( IDT ) and Innovacon, as if the acquisitions of these entities had occurred on January 1, 2005. Pro forma results exclude adjustments for Advanced Clinical Systems Pty Ltd ( ACS ) and CLONDIAG as these acquisitions did not materially affect our results of operations. The pro forma results are derived from the historical financial results of the acquired businesses for all periods presented and are not necessarily indicative of the results that would have occurred had the acquisitions been consummated on January 1, 2005.

| | Three Months Ended March 31, | |
|---|---|---|
| | 2006 | 2005 |
| | (in thousands, except per share amounts) | |
| Pro forma net revenue | $ 141,288 | $ 131,869 |
| Pro forma net loss | $ (1,985) | $ (1,940) |
| Pro forma net loss per common share basic and diluted (1) | $ (0.06) | $ (0.06) |

**(1)** Loss per common share amounts are computed as described in Note 5.

*(d) Restructuring Plans of Acquisitions*

In connection with our acquisitions of BioStar, Ischemia, Ostex International, Inc. ( Ostex ), IVC Industries, Inc. (now operating as Inverness Medical Nutritionals Group or IMN) and certain entities, businesses and intellectual property of Unilever Plc (the Unipath business ), we recorded restructuring costs as part of the respective aggregate purchase prices in accordance with EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*.

The following table sets forth the restructuring costs and accrual balances recorded on a cash basis in connection with the restructuring activities of these acquired businesses (in thousands):

| | Balance at December 31, 2005 | Amounts Paid | Other (1) | Balance at March 31, 2006 |
|---|---|---|---|---|
| BioStar | $ 83 | $ (51) | $ | $ 32 |
| Ischemia | 144 | | | 144 |
| Ostex | 768 | (26) | | 742 |
| IMN | 127 | (11) | | 116 |
| Unipath business | 1,307 | | 15 | 1,322 |
| Total restructuring costs | $ 2,429 | $ (88) | $ 15 | $ 2,356 |

**(1)** Represents foreign currency translation adjustment.

During the fourth quarter of 2005, we established a restructuring plan in connection with our acquisition of BioStar and recorded restructuring costs of $0.5 million, of which $0.4 million related to impairment of fixed assets and $0.1 million related to severance costs associated with a headcount reduction. The total number of employees to be involuntarily terminated was nine, of which seven were terminated as of March 31, 2006. Of the costs recorded during 2005, $0.1 million has been paid as of March 31, 2006. Although we believe our plan and estimated exit costs are reasonable, actual spending for exit activities may differ from current estimated exit costs, which might impact the final aggregate purchase price.

In connection with our acquisition of Ischemia in March 2005, we established a restructuring plan whereby we exited the current facilities of Ischemia in Denver, Colorado and combined its activities with our existing manufacturing and distribution facilities during the third quarter of 2005. Total severance costs associated with involuntarily terminated employees were estimated to be $1.6 million, of which $1.5 million has been paid as of March 31, 2006. We estimated costs to vacate the Ischemia facilities to be approximately $135,000, of which $90,000 has been paid as of March 31, 2006. The total number of involuntarily terminated employees was 17, of which all were terminated as of March 31, 2006.

As a result of our acquisition of Ostex, we established a restructuring plan whereby we exited the facilities of Ostex in Seattle, Washington, and combined the activities of Ostex with our existing manufacturing and distribution facilities. The total number of employees to be terminated involuntarily under the restructuring plan was 38, of which all were terminated as of March 31, 2006. Total severance costs associated with involuntarily terminated employees were $1.6 million, all of which has been paid as of March 31, 2006. Costs to vacate the Ostex facilities are $0.5 million, of which $0.2 million has been paid as of March 31, 2006. Additionally, the remaining costs to exit the operations, primarily facilities lease commitments, were $1.9 million, of which $1.5 million has been paid as of March 31, 2006. Total unpaid exit costs amounted to $0.7 million as of March 31, 2006.

Immediately after the close of the acquisition, we reorganized the business operations of IMN to improve efficiencies and eliminate redundant activities on a company-wide basis. The restructuring affected all cost centers within the organization, but most significantly responsibilities at the sales and executive levels, as such activities were combined with our existing business operations. Also as part of the restructuring plan, we relocated one of IMN s warehouses to a closer proximity of the manufacturing facility to improve efficiency. Of the $1.6 million in total exit costs, which includes severance costs for 47 involuntarily terminated employees and costs to vacate the warehouse, $1.5 million has been paid as of March 31, 2006.

As a result of the acquisition of the Unipath business from Unilever Plc in 2001, we reorganized the operations of the Unipath business for purposes of improving efficiencies and achieving economies of scale on a company-wide basis. Such reorganization affected all major cost centers at the operations in England. Additionally, most business activities of the U.S. division were merged into our existing U.S. businesses. Total exit costs, which primarily related to severance and early retirement obligations for 65 involuntarily terminated employees, were $4.1 million. As of March 31, 2006, $1.3 million, adjusted for foreign exchange effect, in exit costs remained unpaid.

## (9) Restructuring Plan

On May 9, 2005, we committed to a plan to cease operations at our facility in Galway, Ireland. During the three months ended March 31, 2006, we recorded a $2.1 million restructuring charge, of which $0.3 million related to severance, early retirement and outplacement services, $0.1 million related to impairment of fixed assets, $0.5 million related to facility closing costs and $1.2 million related to unrealized foreign exchange losses relating to this plan of termination. The charges for the three months ended March 31, 2006 consisted of $0.7 million charged to cost of goods sold, $0.2 million charged to general and administrative and $1.2 million charged to other expense, of which $0.7 million and $0.2 million of the $0.9 million included in operating income was included in our consumer diagnostic products and professional diagnostic products business segments, respectively.

The total restructuring charges since the commitment date is $7.2 million, of which $2.6 million related to severance, early retirement and outplacement services, $2.4 million related to impairment of fixed assets and inventory, $1.0 million related to facility closing costs and $1.2 million related to unrealized foreign exchange losses relating primarily to this plan of termination. Of the total $5.8 million restructuring charges recorded in operating income, $5.5 million and $0.3 million were included in our consumer diagnostic products and professional diagnostic products business segments, respectively. The total number of employees to be involuntarily terminated is 113, of which 111 were terminated and the remaining two employees will be terminated during the second quarter of 2006. As of March 31, 2006, of the $2.6 million related to severance, early retirement and outplacement services, $0.2 million remained unpaid. Of the $1.0 million in facility closing costs, $0.4 million remained unpaid as of March 31, 2006. Including the charges recorded through March 31, 2006, we expect the total restructuring charge primarily related to the closure of out Galway facility to be approximately $7.3 million, with additional charges relating principally to severance and facility closing costs of $0.1 million expected to be recorded upon final liquidation within the consumer diagnostic products segment. Upon liquidation, we expect to record a gain of approximately $5.2 million, based on foreign currency exchange rates as of March 31, 2006, as the result of a reclassification of the cumulative translation adjustment to other income.

## (10) Co-Development Arrangement

On February 25, 2005, we entered into a co-development agreement with ITI Scotland Limited ( ITI ), whereby ITI agreed to provide us with approximately £30 million (or $52.4 million at March 31, 2006) over three years to partially fund research and development programs focused on identifying novel biomarkers and near-patient and home use tests for cardiovascular and other diseases ( the Programs ). We agreed to invest £37.5 million (or $65.5 million at March 31, 2006) in the Programs over three years from the date of the agreement. Through our subsidiary, Stirling Medical Innovations Limited ( Stirling ), we established a new research center in Stirling, Scotland, where we consolidated many of our existing cardiology programs and will ultimately commercialize products arising from the Programs. ITI and Stirling will have exclusive rights to the developed technology in their respective fields of use. As of March 31, 2006, we had received approximately $26.8 million in funding from ITI. As qualified expenditures are made under the co-development arrangement, we recognize the fee earned during the period as a reduction of our related expenses, subject to certain limitations. For the three months ended March 31, 2006 and 2005, we recognized $4.3 million and $2.4 million of reimbursements, respectively, of which $3.8 million and $1.9 million, respectively, offset our research and development spending and $0.5 million in both periods reduced our general, administrative and marketing spending incurred by Stirling. Funds received from ITI in excess of amounts earned are included in accrued expenses and other current liabilities, the balance of which was $4.3 million as of March 31, 2006.

## (11) Senior Credit Facility

As of December 31, 2005, $89.0 million of borrowings were outstanding under our senior credit facility. On February 8 and 9, 2006, we sold an aggregate 3,400,000 shares of our common stock at $24.41 per share to funds affiliated with 14 accredited institutional investors in a private placement. Proceeds from the private placement were approximately $79.3 million, net of issuance costs of $3.7 million. Of this amount, we repaid principal and interest outstanding under our senior credit facility of $74.1 million, with the remainder of the net proceeds retained for general corporate purposes. On February 27, 2006, we borrowed $13.0 million under our European revolving line of credit to fund our acquisition of CLONDIAG.

On March 31, 2006, we entered into an amendment to our third amended and restated credit agreement. The amendment increased the total amount of credit available to us under the credit agreement to $155.0 million, from $100.0 million consisting of a new $45.0 million U.S. term loan, a $40.0 million U.S. revolving line of credit, reduced from $60.0 million under the credit agreement prior to the amendment, and a $70.0 million European revolving line of credit, increased from $40.0 million under the credit agreement prior to the amendment. On March 31, 2006, in connection with our acquisition of Innovacon, we incurred $58.0 million in indebtedness under the credit agreement when we received the proceeds of the entire U.S. term loan and drew an additional $13.0 million under the U.S. revolving line of credit. Our aggregate indebtedness under the amended credit agreement, including the $58.0 million borrowed on March 31, 2006 for the acquisition of Innovacon, was $86.0 million as of March 31, 2006.

We must repay the U.S. term loan in seven consecutive quarterly installments, beginning on September 30, 2006, in an amount equal to 0.25% of the aggregate $45.0 million of U.S. term loan commitments, with the final installment due on March 31, 2008 in the amount of the remaining principal balance of the U.S. term loan. We may repay any existing or future borrowings under the revolving lines of credit at any time, but no later than March 31, 2008. We are required to make mandatory prepayments in various amounts under the credit facilities if we sell assets not in the ordinary course of business above certain thresholds, if we issue stock or sell equity securities, if we issue subordinated debt or if we have excess cash flow.

Borrowings under the revolving lines of credit and term loan bear interest at either (i) the London Interbank Offered Rate ( LIBOR ), as defined in the agreement, plus applicable margins or, at our option, (ii) a floating Index Rate, as defined in the agreement, plus applicable margins. Applicable margins if we choose to use the LIBOR or the Index Rate can range from 2.75% to 3.75% or 1.50% to 2.50%, respectively, for our revolving line of credit depending on the quarterly adjustments that are based on our consolidated financial performance and 4% or 2.75%, respectively, on our term loan. As of March 31, 2006, the LIBOR and Index rates applicable under our primary senior credit facility for the revolving lines of credit were 8.58% and 10.25%, respectively, and for the U.S. term loan were 8.83% and 10.5%, respectively. For the three months ended March 31, 2006 and 2005, we recorded interest expense, including amortization of deferred financing costs, under these senior credit facilities in the aggregate amount of $1.5 million and $0.7 million, respectively. As of March 31, 2006, accrued interest related to the senior credit facility amounted to $0.2 million.

Borrowings under the credit facilities remain secured by the stock of certain of our U.S. and foreign subsidiaries, substantially all of our intellectual property rights, substantially all of the assets of our businesses in the U.S. and a significant portion of the assets of our businesses outside the U.S. We have pledged certain of the assets and properties, including certain intellectual property rights, acquired in connection with the purchase of Innovacon to secure borrowings under the credit facilities and we expect to pledge certain of the assets and properties still to be acquired to secure borrowings under the credit facilities.

## (12) Defined Benefit Pension Plan

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

| | Three Months Ended March 31, | |
|---|---|---|
| | 2006 | 2005 |
| Service cost | $ | $ 68 |
| Interest cost | 135 | 153 |
| Expected return on plan assets | (112) | (90) |
| Realized losses | 77 | 11 |
| Net periodic benefit cost | $ 100 | $ 142 |

## (13) Financial Information by Segment

Under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision making group is composed of the chief executive officer and members of senior management. Our reportable operating segments are Consumer Diagnostic Products, Vitamins and Nutritional Supplements, Professional Diagnostic Products, and Corporate and Other. Our operating results include license and royalty revenue which are allocated to Consumer Diagnostic Products and Professional Diagnostic Products on the basis of the original license or royalty agreement. Included in the operating loss of Corporate and Other are non-allocable corporate expenditures and expenses related to our research and development activities in the area of cardiology, the latter of which amounted to $5.6 million, net of the ITI funding (Note 10) of $3.8 million, and $4.3 million, net of the ITI funding of $1.9 for the three months ended March 31, 2006 and 2005, respectively. Total assets in the area of cardiology, which are included in Corporate and Other in the tables below, amounted to $42.6 million at March 31, 2006 and $41.2 million at December 31, 2005.

We evaluate performance of our operating segments based on revenue and operating income (loss). Segment information for the three months ended March 31, 2006 and 2005 is as follows (in thousands):

| | Consumer Diagnostic Products | Vitamins and Nutritional Supplements | Professional Diagnostic Products | Corporate and Other | Total |
|---|---|---|---|---|---|
| Three Months Ended March 31, 2006: | | | | | |
| Net revenue to external customers | $ 43,314 | $ 19,003 | $ 65,504 | $ | $ 127,821 |
| Operating income (loss) | $ 8,480 | $ (1,077) | $ 9,416 | $ (11,835) | $ 4,984 |
| Three Months Ended March 31, 2005: | | | | | |
| Net revenue to external customers | $ 43,420 | $ 16,921 | $ 31,579 | $ | $ 91,920 |
| Operating income (loss) | $ 6,941 | $ (1,860) | $ (2,479) | $ (8,790) | $ (6,188) |
| Assets: | | | | | |
| As of March 31, 2006 | $ 249,899 | $ 53,126 | $ 549,291 | $ 53,953 | $ 906,269 |
| As of December 31, 2005 | $ 253,063 | $ 52,967 | $ 434,796 | $ 50,340 | $ 791,166 |

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**(14) Material Contingencies and Legal Settlements**

Due to the nature of our business, we may from time to time be subject to commercial disputes, consumer product claims or various other lawsuits arising in the ordinary course of our business, and we expect this will continue to be the case in the future. These lawsuits generally seek damages, sometimes in substantial amounts, for commercial or personal injuries allegedly suffered and can include claims for punitive or other special damages. In addition, we aggressively defend our patent and other intellectual property rights. This often involves bringing infringement or other commercial claims against third parties, which can be expensive and can results in counterclaims against us. We are currently not a party to any material legal proceedings.

As of March 31, 2006, we had outstanding material contingent contractual obligations related to our acquisitions of ADC, Binax and CLONDIAG. With respect to our acquisition of ADC, the terms of the merger agreement, as amended, provide for $1.5 million of contingent consideration payable to the ADC shareholders upon the successful completion of a new product under development by June 30, 2006. With respect to Binax, the terms of the acquisition agreement provide for $11.0 million of contingent cash consideration payable to the Binax shareholders upon the successful completion of certain new product developments during the five years following the acquisition. With respect to the acquisition of CLONDIAG, the terms of the acquisition agreement provide for $8.9 million of contingent consideration, consisting of 224,316 shares of our common stock and approximately $3.0 million of cash or stock in the event that four specified products are developed on CLONDIAG s platform technology during the three years following the acquisition date.

## (15) Recent Accounting Pronouncements

*Recently Issued Standards*

In February 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS No. 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided we have not yet issued financial statements, including for interim periods, for that fiscal year. We do not expect the adoption of SFAS No. 155 to have a material impact on our financial position, results of operations or cash flows.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140.* SFAS No. 156 requires that all separately recognized servicing rights be initially measured at fair value, if practicable. In addition, this Statement permits an entity to choose between two measurement methods (amortization method or fair value measurement method) for each class of separately recognized servicing assets and liabilities. This new accounting standard is effective January 1, 2007. The adoption of SFAS No. 156 is not expected to have an impact on our financial position, results of operations or cash flows.

*Recently Adopted Standards*

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs - an amendment of ARB No. 43, Chapter 4*. SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage). In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on normal capacity of production facilities. As required by SFAS No. 151, we adopted this new accounting standard on January 1, 2006. The adoption of SFAS No. 151 did not have a material impact on our financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123-R, *Share-Based Payment,* which addresses the accounting for transactions in which a company receives employee services in exchange for (a) equity instruments of the company or (b) liabilities that are based on the fair value of the company s equity instruments or that may be settled by the issuance of such equity instruments. Under the original guidance of SFAS No. 123-R, we were to adopt the statement s provisions for the interim period beginning after June 15, 2005. However, in April 2005, as a result of an action by the Securities and Exchange Commission, companies were allowed to adopt the provisions of SFAS No. 123-R at the beginning of their fiscal year that begins after June 15, 2005. Consequently, we adopted SFAS No. 123-R on January 1, 2006. See Note 4 for further discussion.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections,* which replaces APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. The statement requires a voluntary change in accounting principle be applied retrospectively to all prior period financial statements so that those financial statements are presented as if the current accounting principle had always been applied. APB Opinion No. 20 previously required most voluntary changes in accounting principle to be recognized by including in net income of the period of change the cumulative effect of changing to the new accounting principle. In addition, SFAS No. 154 carries forward, without change, the guidance contained in APB Opinion No. 20 for reporting a correction of an error in previously issued financial statements and a change in accounting estimate. SFAS No. 154 was effective for accounting changes and corrections of errors made after January 1, 2006. The adoption of SFAS No. 154 had no impact on our financial statements.

## (16) Guarantor Financial Information

We issued $150.0 million in senior subordinated notes (the Bonds ) to qualified institutional buyers in reliance on Rule 144A under the Securities Act of 1933, as amended (the Securities Act ), and outside the United States in compliance with Regulation S of the Securities Act. Our payment obligations under the Bonds are currently guaranteed by all of our domestic subsidiaries (the Guarantor Subsidiaries ). The guarantee is full and unconditional. Separate financial statements of the Guarantor Subsidiaries are not presented because we have determined that they would not be material to investors in the Bonds. The following supplemental financial information sets forth, on a consolidating basis, the statements of operations and cash flows for the three months ended March 31, 2006 and 2005 and the balance sheets as of March 31, 2006 and December 31, 2005 for our company (the Issuer ), the Guarantor Subsidiaries and our other subsidiaries (the Non-Guarantor Subsidiaries ). The supplemental financial information reflects our investments and the Guarantor Subsidiaries investments in the Guarantor and Non-Guarantor Subsidiaries using the equity method of accounting.

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

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF OPERATIONS**
**For the Three Months Ended March 31, 2006**

(unaudited)
(in thousands)

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| Net product sales | $ 5,887 | $ 72,877 | $ 61,252 | $ (17,263) | $ 122,753 |
| License and royalty revenue | | 71 | 4,997 | | 5,068 |
| **Net revenue** | 5,887 | 72,948 | 66,249 | (17,263) | 127,821 |
| Cost of sales | 6,697 | 51,012 | 34,929 | (17,071) | 75,567 |
| **Gross profit** | (810) | 21,936 | 31,320 | (192) | 52,254 |
| Operating expenses: | | | | | |
| Research and development | 983 | 1,928 | 7,699 | | 10,610 |
| Sales and marketing | 1,302 | 10,084 | 9,436 | | 20,822 |
| General and administrative | 5,152 | 3,876 | 6,810 | | 15,838 |
| Total operating expenses | 7,437 | 15,888 | 23,945 | | 47,270 |
| **Operating (loss) income** | (8,247) | 6,048 | 7,375 | (192) | 4,984 |
| Equity in earnings of subsidiaries, net of tax | 7,271 | | | (7,271) | |
| Interest expense, including amortization of discounts and write-off of deferred financing costs | (4,079) | (796) | (2,523) | 1,677 | (5,721) |
| Other income (expense), net | 2,703 | (99) | (1,355) | (1,677) | (428) |
| **(Loss) income before provision for income taxes** | (2,352) | 5,153 | 3,497 | (7,463) | (1,165) |
| Provision for income taxes | 278 | 554 | 633 | | 1,465 |
| **Net (loss) income** | $ (2,630) | $ 4,599 | $ 2,864 | $ (7,463) | $ (2,630) |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF OPERATIONS**
**For the Three Months Ended March 31, 2005**

(unaudited)
(in thousands)

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| Net product sales | $ 5,478 | $ 51,086 | $ 45,339 | $ (12,204) | $ 89,699 |
| License and royalty revenue | | 31 | 2,190 | | 2,221 |
| **Net revenue** | 5,478 | 51,117 | 47,529 | (12,204) | 91,920 |
| Cost of sales | 5,617 | 43,048 | 24,564 | (13,498) | 59,731 |
| **Gross profit** | (139) | 8,069 | 22,965 | 1,294 | 32,189 |
| Operating expenses: | | | | | |
| Research and development | 141 | 1,115 | 5,976 | | 7,232 |
| Sales and marketing | 480 | 7,177 | 9,373 | | 17,030 |
| General and administrative | 3,308 | 3,622 | 7,185 | | 14,115 |
| Total operating expenses | 3,929 | 11,914 | 22,534 | | 38,377 |
| **Operating (loss) income** | (4,068) | (3,845) | 431 | 1,294 | (6,188) |
| Equity in earnings of subsidiaries, net of tax | 3,907 | | | (3,907) | |
| Interest expense, including amortization of original issue discounts and write-off of deferred financing costs | (4,245) | (484) | (1,343) | 1,060 | (5,012) |
| Other income (expense), net | (3,074) | 8,660 | 324 | (999) | 4,911 |
| **(Loss) income before income taxes** | (7,480) | 4,331 | (588) | (2,552) | (6,289) |
| Provision for income taxes | 322 | 718 | 473 | | 1,513 |
| **Net (loss) income** | $ (7,802) | $ 3,613 | $ (1,061) | $ (2,552) | $ (7,802) |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING BALANCE SHEET**
**March 31, 2006**

(unaudited)
(in thousands)

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current Assets:** | | | | | |
| Cash and cash equivalents | $ 306 | $ 9,743 | $ 23,476 | $ | $ 33,525 |
| Accounts receivable, net of allowances | 2,632 | 48,165 | 38,106 | | 88,903 |
| Inventories | 7,438 | 41,021 | 27,339 | (6,292) | 69,506 |
| Deferred tax assets | | 1 | 844 | | 845 |
| Prepaid expenses and other current assets | 3,817 | 2,833 | 11,812 | | 18,462 |
| Intercompany receivables | 35,555 | 28,133 | 16,345 | (80,033) | |
| **Total current assets** | 49,748 | 129,896 | 117,922 | (86,325) | 211,241 |
| Property, plant and equipment, net | 2,222 | 30,522 | 42,333 | | 75,077 |
| Goodwill | 116,971 | 109,116 | 146,626 | | 372,713 |
| Other intangible assets with indefinite lives | 5,000 | 21,120 | 46,206 | | 72,326 |
| Core technology and patents, net | 19,824 | 13,085 | 29,560 | | 62,469 |
| Other intangible assets, net | 35,181 | 37,378 | 27,063 | | 99,622 |
| Deferred financing costs, net and other non-current assets | 5,321 | 2,255 | 4,420 | | 11,996 |
| Deferred tax assets | 134 | | 691 | | 825 |
| Investment in subsidiaries | 355,211 | (1,281) | | (353,930) | |
| Intercompany notes receivable | 143,606 | 54,650 | 3 | (198,259) | |
| **Total assets** | $ 733,218 | $ 396,741 | $ 414,824 | $ (638,514) | $ 906,269 |
| | | | | | |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | | | | |
| | | | | | |
| **Current liabilities:** | | | | | |
| Current portion of long-term debt | $ | $ | $ 1,850 | $ | $ 1,850 |
| Current portion of capital lease obligations | | 517 | 35 | | 552 |
| Accounts payable | 6,194 | 16,483 | 13,814 | | 36,491 |
| Accrued expenses and other current liabilities | 20,388 | 21,680 | 36,602 | | 78,670 |
| Intercompany payables | 17,849 | 35,451 | 26,733 | (80,033) | |
| **Total current liabilities** | 44,431 | 74,131 | 79,034 | (80,033) | 117,563 |
| **Long-term liabilities:** | | | | | |
| Long-term debt, net of current portion | 169,506 | 58,000 | 28,124 | | 255,630 |
| Capital lease obligations, net of current portion | | 777 | 57 | | 834 |
| Deferred tax liabilities | 4,231 | 6,510 | 9,000 | 127 | 19,868 |
| Other long-term liabilities | | 285 | 5,384 | | 5,669 |
| Intercompany notes payable | 8,345 | 50,379 | 139,535 | (198,259) | |
| **Total long-term liabilities** | 182,082 | 115,951 | 182,100 | (198,132) | 282,001 |
| **Stockholders equity** | 506,705 | 206,659 | 153,690 | (360,349) | 506,705 |
| **Total liabilities and stockholders equity** | $ 733,218 | $ 396,741 | $ 414,824 | $ (638,514) | $ 906,269 |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING BALANCE SHEET**
**December 31, 2005**

(unaudited)
(in thousands)

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current Assets:** | | | | | |
| Cash and cash equivalents | $ 1,196 | $ 8,080 | $ 24,994 | $ | $ 34,270 |
| Accounts receivable, net of allowances | 2,344 | 34,834 | 33,298 | | 70,476 |
| Inventories | 7,518 | 42,794 | 26,997 | (6,100) | 71,209 |
| Deferred tax assets | | | 844 | | 844 |
| Prepaid expenses and other current assets | 2,228 | 2,720 | 12,586 | | 17,534 |
| Intercompany receivables | 38,919 | 34,346 | 19,974 | (93,239) | |
| **Total current assets** | 52,205 | 122,774 | 118,693 | (99,339) | 194,333 |
| Property, plant and equipment, net | 2,632 | 31,164 | 38,415 | | 72,211 |
| Goodwill | 72,787 | 109,637 | 139,786 | | 322,210 |
| Other intangible assets with indefinite lives | 8,700 | 12,420 | 42,622 | | 63,742 |
| Core technology and patents, net | 28,269 | 5,556 | 30,225 | | 64,050 |
| Other intangible assets, net | 20,321 | 18,429 | 21,739 | | 60,489 |
| Deferred financing costs, net, and other non-current assets | 6,696 | 2,347 | 4,426 | | 13,469 |
| Deferred tax assets | | | 662 | | 662 |
| Investment in subsidiaries | 297,607 | (1,162) | | (296,445) | |
| Intercompany notes receivable | 130,001 | 43,066 | | (173,067) | |
| **Total assets** | $ 619,218 | $ 344,231 | $ 396,568 | $ (568,851) | $ 791,166 |
| | | | | | |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | | | | |
| | | | | | |
| **Current liabilities:** | | | | | |
| Current portion of long-term debt | $ | $ | $ 2,367 | $ | $ 2,367 |
| Current portion of capital lease obligations | | 508 | 34 | | 542 |
| Accounts payable | 1,549 | 25,438 | 15,168 | | 42,155 |
| Accrued expenses and other current liabilities | 12,935 | 22,939 | 28,872 | | 64,746 |
| Intercompany payables | 34,070 | 31,357 | 27,812 | (93,239) | |
| **Total current liabilities** | 48,554 | 80,242 | 74,253 | (93,239) | 109,810 |
| **Long-term liabilities:** | | | | | |
| Long-term debt, net of current portion | 169,456 | 60,000 | 29,161 | | 258,617 |
| Capital lease obligations, net of current portion | | 914 | 64 | | 978 |
| Deferred tax liabilities | 3,900 | 5,964 | 8,889 | 128 | 18,881 |
| Other long-term liabilities | | 278 | 5,294 | | 5,572 |
| Intercompany notes payable | | 42,331 | 130,736 | (173,067) | |
| **Total long-term liabilities** | 173,356 | 109,487 | 174,144 | (172,939) | 284,048 |
| **Stockholders equity** | 397,308 | 154,502 | 148,171 | (302,673) | 397,308 |
| **Total liabilities andstockholders equity** | $ 619,218 | $ 344,231 | $ 396,568 | $ (568,851) | $ 791,166 |

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**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF CASH FLOWS**
**For the Three Months Ended March 31, 2006**

(unaudited)
(in thousands)

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | | | |
| Net (loss) income | $ (2,630) | $ 4,599 | $ 2,864 | $ (7,463) | $ (2,630) |
| Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities: | | | | | |
| Equity in earnings of subsidiaries, net of tax | (7,271) | | | 7,271 | |
| Interest expense related to amortization and write-off of non-cash original issue discount and deferred financing costs | 296 | 216 | 165 | | 677 |
| Depreciation and amortization | 1,603 | 2,337 | 3,706 | | 7,646 |
| Non-cash income related to currency hedge | (217) | | | | (217) |
| Deferred income taxes | 196 | 546 | 1 | | 743 |
| Other non-cash items | 159 | 18 | (36) | | 141 |
| Non-cash stock-based compensation expense | 1,318 | | | | 1,318 |
| Changes in assets and liabilities, net of acquisitions: | | | | | |
| Accounts receivable, net | (288) | (2,291) | (3,729) | | (6,308) |
| Inventories | 80 | 3,873 | 268 | 192 | 4,413 |
| Prepaid expenses and other current assets | (1,589) | 84 | 725 | | (780) |
| Intercompany payables or receivables | (1,474) | 4,887 | (2,097) | (1,316) | |
| Accounts payable | 3,645 | (9,205) | (1,807) | | (7,367) |
| Accrued expenses and other current liabilities | (3,256) | (1,984) | 771 | | (4,469) |
| Other non-current liabilities | | 7 | 84 | | 91 |
| **Net cash (used in) provided by operating activities** | (9,428) | 3,087 | 915 | (1,316) | (6,742) |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF CASH FLOWS (Continued)**
**For the Three Months Ended March 31, 2006**

(unaudited)
(in thousands)

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Cash Flows from Investing Activities:** | | | | | |
| Purchases of property, plant and equipment | (135) | (1,093) | (3,121) | | (4,349) |
| Proceeds from sale of property, plant and equipment | | 6 | 27 | | 33 |
| Cash paid for acquisitions and transactional costs, net of cash acquired | (58,584) | (26) | (11,559) | | (70,169) |
| Decrease (increase) in other assets | 1,122 | (16) | (66) | | 1,040 |
| **Net cash (used in) provided by investing activities** | (57,597) | (1,129) | (14,719) | | (73,445) |
| **Cash Flows from Financing Activities:** | | | | | |
| Cash paid for financing costs | 8 | (167) | (157) | | (316) |
| Proceeds from issuance of common stock, net of issuance costs | 82,128 | | | | 82,128 |
| Net repayment under revolving line of credit | | (2,000) | (1,654) | | (3,654) |
| Repayments of notes payable | | | (42) | | (42) |
| Principal payments of capital lease obligations | | (128) | (9) | | (137) |
| Intercompany notes payable (receivable) | (16,000) | 2,000 | 14,000 | | |
| **Net cash provided by (used in) financing activities** | 66,136 | (295) | 12,138 | | 77,979 |
| Foreign exchange effect on cash and cash equivalents | | | 147 | 1,316 | 1,463 |
| **Net (decrease) increase in cash and cash equivalents** | (889) | 1,663 | (1,519) | | (745) |
| **Cash and cash equivalents, beginning of period** | 1,195 | 8,080 | 24,995 | | 34,270 |
| **Cash and cash equivalents, end of period** | $ 306 | $ 9,743 | $ 23,476 | $ | $ 33,525 |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF CASH FLOWS**
**For the Three Months Ended March 31, 2005**

(unaudited)
(in thousands)

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | | | |
| Net (loss) income | $ (7,802) | $ 3,613 | $ (1,061) | $ (2,552) | $ (7,802) |
| Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities: | | | | | |
| Equity in earnings of subsidiaries, net of tax | (3,907) | | | 3,907 | |
| Interest expense related to amortization and write-off of non-cash original issue discount and deferred financing costs | 292 | 96 | 55 | | 443 |
| Depreciation and amortization | 304 | 2,285 | 3,613 | | 6,202 |
| Deferred income taxes | 112 | 526 | | | 638 |
| Other non-cash items | (29) | (6) | (37) | | (72) |
| Minority interest in subsidiary | | | 207 | | 207 |
| Non-cash charge relating to currency hedge | 4 | | | | 4 |
| Changes in assets and liabilities, net of acquisitions: | | | | | |
| Accounts receivable, net | 726 | 5,079 | 2,883 | | 8,688 |
| Inventories | 510 | (557) | (1,595) | (1,355) | (2,997) |
| Prepaid expenses and other current assets | (857) | (640) | (2,979) | | (4,476) |
| Intercompany payables or receivables | 5,790 | (2,900) | (3,304) | 414 | |
| Accounts payable | 1,098 | 1,329 | 2,921 | | 5,348 |
| Accrued expenses and other current liabilities | 289 | (1,259) | 10,018 | | 9,048 |
| Other non-current liabilities | | | 76 | | 76 |
| **Net cash (used in) provided by operating activities** | (3,470) | 7,566 | 10,797 | 414 | 15,307 |

**INVERNESS MEDICAL INNOVATIONS, INC. AND SUBSIDIARIES**
**CONSOLIDATING STATEMENT OF CASH FLOWS (Continued)**
**For the Three Months Ended March 31, 2005**

(unaudited)
(in thousands)

| | Issuer | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **Cash Flows from Investing Activities:** | | | | | |
| Purchases of property, plant and equipment | (275) | (1,342) | (2,362) | | (3,979) |
| Proceeds from sale of property, plant and equipment | | 6 | 37 | | 43 |
| Payments of transactional costs for previous acquisitions | (12,492) | 1,671 | (4,955) | | (15,776) |
| Increase in other assets | (231) | 37 | (200) | | (394) |
| **Net cash used in investing activities** | (12,998) | 372 | (7,480) | | (20,106) |
| | | | | | |
| **Cash Flows from Financing Activities:** | | | | | |
| Cash paid for financing costs | (82) | (163) | (110) | | (355) |
| Proceeds from issuance of common stock, net of issuance costs | 899 | | | | 899 |
| Net repayment under revolving line of credit | (77) | | 22,247 | | 22,170 |
| Repayments of notes payable | | | (9) | | (9) |
| Principal payments of capital lease obligations | | (113) | (2) | | (115) |
| Intercompany notes (payables) or receivables | 16,000 | | (16,000) | | |
| **Net cash provided by (used in) financing activities** | 16,740 | (276) | 6,126 | | 22,590 |
| Foreign exchange effect on cash and cash equivalents | | | (466) | (414) | (880) |
| **Net increase in cash and cash equivalents** | 272 | 7,662 | 8,977 | | 16,911 |
| **Cash and cash equivalents, beginning of period** | 12 | 3,551 | 13,193 | | 16,756 |
| **Cash and cash equivalents, end of period** | $ 284 | $ 11,213 | $ 22,170 | $ | $ 33,667 |

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

**Financial Overview**

As a leading global manufacturer and supplier of rapid diagnostic products for consumer and professional markets, we are continually exploring new opportunities for our proprietary electrochemical and other technologies in a variety of professional diagnostic and consumer-oriented applications, including immuno-diagnostics with a focus on women s health, cardiology and infectious disease. Our emphasis on new product development requires substantial investment and involves significant inherent risk. Our new product development efforts, as well as our position as a leading supplier of consumer pregnancy and fertility/ovulation tests and rapid point-of-care diagnostics, are supported by the strength of our intellectual property portfolio. We intend to continue to devote substantial resources to research and development activities. Our February 2005 co-development agreement with ITI Scotland Limited ( ITI ), who agreed to provide us with approximately 30 million British Pounds Sterling over three years to fund certain new and existing cardiovascular-related research and development initiatives, as well as development of our new cardiac center in Stirling, Scotland, is evidence of this commitment. In addition, we will continue to aggressively defend our substantial intellectual property portfolio, which underlies our emphasis on new product development, against potential infringers.

For the three months ended March 31, 2006, we recorded net revenue of $127.8 million, compared to $91.9 million for the three months ended March 31, 2005. Adjusted for the unfavorable impact of currency translation, net revenue of $130.0 million for the first quarter of 2006 was approximately 41% higher than the first quarter of 2005. Primarily as a result of our acquisitions, our combined consumer and professional diagnostics businesses experienced a 46% growth, adjusted for the impact of currency translation, while our nutritional business, with net revenue of approximately $19.0 million, experienced an increase of 12% from the first quarter of 2005.

For the three months ended March 31, 2006, we incurred a net loss of $2.6 million, compared to a net loss of $7.8 million for the three months ended March 31, 2005. The improvement in net loss for the first quarter of 2006, compared to the first quarter of 2005, resulted from: (i) an increase in our diagnostics business largely due to our recent acquisitions of Binax, the Determine business, BioStar and IDT, (ii) an increase in royalty revenue relating to the impact of the ongoing royalty earned during the recent quarter from our settlement with Quidel Corporation and (iii) an increase in our nutritional business revenue.

During the three months ended March 31, 2006, the Company acquired 67.45% of CLONDIAG chip technologies GmbH ( CLONDIAG ), a private company located in Jena in Germany which has developed a multiplexing technology for nucleic acid and immunoassay-based diagnostics, for a preliminary aggregate purchase price of $22.7 million and acquired the assets of ACON Laboratories business of researching, developing, manufacturing, marketing and selling lateral flow immunoassay and directly-related products ( Innovacon ) for a preliminary aggregate purchase price of approximately $90.2 million.

**Results of Operations**

**Net Product Sales, Total and by Business Segment.** Total net product sales increased by $33.1 million, or 37%, to $122.8 million for the three months ended March 31, 2006 from $89.7 million for the three months ended March 31, 2005. Excluding the unfavorable impact of currency translation, net product sales for the three months ended March 31, 2006 increased by $35.4 million, compared to the three months ended March 31, 2005. Net product sales by business segment for the three months ended March 31, 2006 and 2005 are as follows (in thousands):

| | Three Months Ended March 31, | | % |
|---|---|---|---|
| | 2006 | 2005 | Change |
| Consumer diagnostic products | $ 41,198 | $ 41,935 | (2)% |
| Vitamins and nutritional supplements | 19,003 | 16,921 | 12 % |
| Professional diagnostic products | 62,552 | 30,843 | 103 % |
| Total net product sales | $ 122,753 | $ 89,699 | 37 % |

Adjusted for currency translation impact, net product sales of our consumer diagnostic products increased by $0.7 million, or 2%, comparing the three months ended March 31, 2006 to the three months ended March 31, 2005. This increase represents organic growth in our premium pregnancy test products.

Comparing the three months ended March 31, 2006 to the three months ended March 31, 2005, our vitamins and nutritional supplements business increased by $2.1 million, or 12%.

Adjusted for currency translation impact, net product sales of our professional diagnostic products increased by $32.6 million, or 105%, comparing the three months ended March 31, 2006 to the three months ended March 31, 2005. Of the currency adjusted

increase, revenue increased as a result of our acquisitions, primarily Binax in March 2005 which contributed $9.7 million; the Determine business in June 2005 which contributed $8.2 million; IDT in September 2005 which contributed $3.8 million; BioStar in September 2005 which contributed $8.6 million; and CLONDIAG in February 2006 which contributed $0.1 million, for a total contribution of $30.5 million of net product sales during the three months ended March 31, 2006. Excluding the impact from currency translation, net product sales of our professional diagnostic products increased by $31.7 million, or 103%, comparing the three months ended March 31, 2006 to the three months ended March 31, 2005.

**License and Royalty Revenue.** License and royalty revenue represents license and royalty fees from intellectual property license agreements with third-parties. License and royalty revenue increased by $2.8 million, or 128%, to $5.1 million for the three months ended March 31, 2006 from $2.2 million for the three months ended March 31, 2005. The increase relates to the impact of the ongoing royalty earned during the three months ended March 31, 2006 from royalties from Quidel.

**Gross Profit and Margin.** Gross profit increased by $20.1 million, or 62%, to $52.3 million for the three months ended March 31, 2006 from $32.2 million for the three months ended March 31, 2005. Gross profit during the three months ended March 31, 2006 benefited from higher royalties and higher than average margins earned on revenue from our recently acquired businesses. Included in gross profit for the three months ended March 31, 2006 was a restructuring charge of $0.7 million related to the closure of our Galway, Ireland manufacturing facility and a charge of $0.1 million for stock based compensation related to our January 1, 2006 adoption of Statement of Financial Accounting Standards ( SFAS ) No. 123-R, *Share-Based Payment.*

Overall gross margin for the three months ended March 31, 2006 was 41%, compared to 35% for the three months ended March 31, 2005. Excluding the impact of the restructuring charge and stock-based compensation, gross margin was 42% for the three months ended March 31, 2006. Gross profit for the three months ended March 31, 2005 included a $1.6 million charge for returns and inventory reserve related to the recall of the drugs of abuse diagnostic products. Excluding the effect of the provisions for returns and inventory reserve related to the recall of the drugs of abuse diagnostic products, gross margin for the three months ended March 31, 2005 was 37%.

**Gross Profit from Net Product Sales by Business Segment.** Gross profit from net product sales represents total gross profit less gross profit associated with license and royalty revenue. Gross profit from total net product sales increased by $17.6 million, or 57%, to $48.6 million for the three months ended March 31, 2006 from $31.0 million for the three months ended March 31, 2005. Gross profit from net product sales by business segment for the three months ended March 31, 2006 and 2005 are as follows (in thousands):

| | Three Months Ended March 31, | | % |
|---|---|---|---|
| | 2006 | 2005 | Change |
| Consumer diagnostic products | $ 20,296 | $ 20,924 | (3 )% |
| Vitamins and nutritional supplements | 834 | 689 | 21 % |
| Professional diagnostic products | 27,434 | 9,350 | 193 % |
| Total gross profit from net product sales | $ 48,564 | $ 30,964 | 57 % |

Gross profit from our consumer diagnostic product sales decreased by $0.6 million, or 3%, to $20.3 million for the first quarter of 2006 compared to $20.9 million for the first quarter of 2005. Factors contributing to the decrease during the three months ended March 31, 2006 included a restructuring charge of $0.7 million related to the closure of our Galway, Ireland manufacturing facility and a charge of $0.1 million for stock-based compensation related to our January 1, 2006 adoption of SFAS No. 123-R. Excluding the impact of the restructuring charge and stock-based compensation expense, gross profit for the three months ended March 31, 2006 was $21.1 million, which represents an increase of $0.1 million, or 1%, as compared with the three months ended March 31, 2005. As a percentage of our consumer diagnostic product sales, gross margin, excluding the impact of the restructuring charge and stock-based compensation, for the three months ended March 31, 2006 was 51% compared with a gross margin percentage of 50% for the three months ended March 31, 2005.

Comparing the first quarter of 2006 to the first quarter of 2005, gross profit from our vitamins and nutritional supplements product sales was relatively flat with an increase of $0.1 million, or 21%, to $0.8 million from $0.6 million. As a percentage of net product sales, gross profit for

our vitamins and nutritional supplements business was approximately 4% during each of the quarters ended March 31, 2006 and 2005.

Gross profit from our professional diagnostic product sales increased by $18.1 million, or 193%, to $27.4 million for the first quarter of 2006 compared to $9.4 million for the first quarter of 2005. The increase in gross profit is largely attributable to the increase in product sales resulting primarily from our acquisitions of Binax, BioStar and the Determine business, where higher margin products are manufactured. As a percentage of our professional diagnostic product sales, gross margin for the first quarter of 2006

was 44%. Gross margin for the first quarter of 2005 included a $1.6 million charge related to a recall of the drugs of abuse diagnostic products. Excluding the impact of this recall, gross margin for the first quarter of 2005 was 35%.

**Research and Development Expense.** Research and development expense increased by $3.4 million, or 47%, to $10.6 million for the three months ended March 31, 2006 from $7.2 million for the three months ended March 31, 2005. The increase was primarily the result of $2.2 million of increased spending related to our cardiology research programs, $2.2 million additional spending related to our acquisitions of Binax, BioStar and CLONDIAG, a $0.3 million charge for stock-based compensation related to our January 1, 2006 adoption of SFAS No. 123-R. The amount of research and development expense for the first quarter of 2006, or $10.6 million, was partially offset by $3.8 million of funding from ITI earned during the quarter, which represented an increase in funding of $1.9 million over the comparable quarter in 2005 and $0.6 million of favorable impact resulting from foreign currency translation.

**Sales and Marketing Expense.** Sales and marketing expense increased by $3.8 million, or 22%, to $20.8 million for the three months ended March 31, 2006 from $17.0 million for the three months ended March 31, 2005. The increase in sales and marketing expense was primarily the result of approximately $4.2 million of additional spending related to our acquisitions, primarily Binax, BioStar and IDT and a $0.2 million charge for stock-based compensation related to our January 1, 2006 adoption of SFAS No. 123-R, partially offset by a $0.6 million of favorable impact resulting from foreign currency translation.

Sales and marketing expense as a percentage of net product sales decreased to 16% for the three months ended March 31, 2006, compared to 19% for the three months ended March 31, 2005.

**General and Administrative Expense.** General and administrative expense increased by $1.7 million, or 12%, to $15.8 million for the three months ended March 31, 2006 from $14.1 million for the three months ended March 31, 2005. Approximately $2.1 million of the increase in general and administrative expense resulted from additional spending related to our acquisitions of Binax, BioStar, IDT and the Determine business, along with a $0.8 million charge for stock-based compensation related to our January 1, 2006 adoption of SFAS No. 123-R, offset by a decrease in legal spending of $2.1 million and a $0.3 million of favorable impact resulting from foreign currency translation.

**Interest Expense.** Interest expense includes interest charges, the write-off and amortization of deferred financing costs and the amortization of non-cash discounts associated with our debt issuances. Interest expense increased by $0.7 million, or 14%, to $5.7 million for the three months ended March 31, 2006 from $5.0 million for the three months ended March 31, 2005. Such increase was partially due to a higher average outstanding debt balance which was $260.7 million during the three months ended March 31, 2006, compared to $202.3 million during the three months ended March 31, 2005, as a result of borrowings to fund various acquisitions and operations. Additionally, higher applicable interest rates on the senior credit facility during the three months ended March 31, 2006 compared with the three months ended March 31, 2005 and an increase in the amortization of deferred financing costs related to the debt refinancings that occurred later in fiscal year 2005 and during the first quarter of 2006 contributed to the increase in interest expense.

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

| | Three Months Ended March 31, | | $ |
|---|---|---|---|
| | 2006 | 2005 | Change |

| | | | |
|---|---|---|---|
| Interest income | $ 333 | $ 238 | $ 95 |
| Foreign exchange gains (losses), net | (1,610) | 185 | (1,795) |
| Other | 849 | 4,488 | (3,639) |
| Total other (expense) income, net | $ (428) | $ 4,911 | $ (5,339) |

Included in the foreign exchange gains (losses), net for the three months ended March 31, 2006 was a $1.2 million unrealized foreign exchange loss associated with the closure of our Galway, Ireland manufacturing facility. Other income of $0.8 million included $0.2 million of income related to a foreign currency exchange contract, a $0.8 million gain on a legal settlement related to the resolution of a contingency related to our 2003 acquisition of ABI, and $0.2 million of additional expense related to a legal settlement of a class action suit against several raw material suppliers in our vitamins and nutritional supplements business.

**Provision for Income Taxes.** Provision for income taxes was $1.5 million for the three months ended March 31, 2006 which was relatively flat from $1.5 million for the three months ended March 31, 2005. The effective tax rate was (126)% for the three months ended March 31, 2006, compared to (24)% for the three months ended March 31, 2005. The income tax provision for both periods is primarily related to the recognition of U.S. deferred tax liabilities for temporary differences between the book and tax basis

of goodwill and certain intangible assets with indefinite lives, state income tax provision and foreign income tax provisions for various foreign subsidiaries.

**Net Loss**. We incurred a net loss of $2.6 million, or $0.09 per basic and diluted common share, for the three months ended March 31, 2006, compared to a net loss of $7.8 million, or $0.37 per basic and diluted common share, for the three months ended March 31, 2005. The decrease in net loss for the three months ended March 31, 2006, compared to the three months ended March 31, 2005, primarily resulted from the various factors as discussed above. See Note 5 of the accompanying consolidated financial statements for the calculation of net loss per common share.

**Liquidity and Capital Resources**

Based upon our current working capital position, current operating plans and expected business conditions, we believe that our existing capital resources, credit facilities and expected funding resulting from our co-development funding agreement with ITI will be adequate to fund our operations, including our outstanding debt and other commitments, as discussed below, for the next 12 months. We expect to fund our working capital needs and other commitments primarily through the co-development funding program with ITI and through our operating cash flow, which we expect to improve as we grow our business through new product introductions and by continuing to leverage our strong intellectual property position. We also expect to rely on our credit facilities to fund a portion of our capital needs and other commitments.

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

*Changes in Cash Position*

As of March 31, 2006, we had cash and cash equivalents of $33.5 million, a $0.7 million decrease from December 31, 2005. Since our split off from our former parent company in November 2001, we have funded our business through operating cash flows, proceeds from borrowings and the issuance of equity securities. Our primary source of cash during the three months ended March 31, 2006, included $82.1 million in proceeds from the issuance of our common stock as well as common stock issues under employee stock option and stock purchase plans. During the three months ended March 31, 2006, we used $6.7 million of cash to fund our operating activities, which resulted from our net loss of $2.6 million and a $14.4 million use of cash associated with an increase in working capital, offset by $10.3 million of non-cash items. Our investing activities during the three months ended March 31, 2006 used $73.4 million of cash and consisted primarily of $70.2 million of cash used for acquisitions and $4.3 million of capital equipment purchases. Our non-equity financing activities, primarily borrowings under our primary senior credit facility, net of various debt repayments and financing costs, used cash of $4.1 million during the three months ended March 31, 2006. Fluctuations in foreign currencies favorably impacted our cash balance by $1.4 million during the three months ended March 31, 2006.

*Investing Activities*

During the three months ended March 31, 2006, we paid $70.2 million in cash for acquisitions and transaction related costs, net of cash acquired, primarily with respect to our acquisitions of CLONDIAG and Innovacon during this period.

On February 28, 2006, we acquired 67.45% of CLONDIAG, a private company located in Jena in Germany which has developed a multiplexing technology for nucleic acid and immunoassay based diagnostics. The acquisition agreement provides that we will purchase the remaining 32.55% on or before August 1, 2006. The aggregate purchase price was $22.7 million, which consisted of $11.8 million in cash, 218,502 shares of our common stock with an aggregate fair value of $5.8 million and a $5.1 million payable to acquire the remaining 32.55% stock ownership. The terms of the acquisition agreement also provide for contingent consideration totaling approximately $8.9 million consisting of 224,316 shares of common stock and approximately $3.0 million of cash or stock in the event that four specified products are developed on

CLONDIAG s platform technology during the three years following the acquisition date. This contingent consideration will be accounted for as an increase in the aggregate purchase price, if and when the contingency occurs.

On March 31, 2006, we acquired Innovacon, consisting of the assets of ACON Laboratories business of researching, developing, manufacturing, marketing and selling lateral flow immunoassay and directly-related products in the United States, Canada, Europe (excluding Russia, the former Soviet Republics that are not part of the European Union, Spain, Portugal and Turkey), Israel, Australia, Japan and New Zealand. The preliminary aggregate purchase price was approximately $90.2 million which consisted of $55.1 million in cash, 711,676 shares of our common stock with an aggregate fair value of $19.7 million, $5.4 million in estimated direct acquisition costs and an additional minimum liability of $10.0 million payable to the sellers on the deferred payment date, pursuant to the acquisition agreement. In addition to the amounts described above, we will be required to make additional payments of between $56.1 million to $91.1 million upon the completion of the construction, permitting and validation of a newly constructed manufacturing facility in Hangzhou, China and regulatory clearance in Spain and Portugal. $31.25 million of the remaining payments will be made through the issuance of our common stock, with the balance payable in cash. The timing and amount of any such payments is contingent upon the successful completion of various milestones, as defined in the acquisition agreement, and certain regulatory approvals.

*Financing Activities*

On February 8 and 9, 2006, we sold an aggregate 3,400,000 shares of our common stock at $24.41 per share to funds affiliated with 14 accredited institutional investors in a private placement. Proceeds from the private placement were approximately $79.3 million, net of issuance costs of $3.7 million. Of this amount, we repaid principal and interest outstanding under our senior credit facility of $74.1 million, with the remainder of the net proceeds retained for general corporate purposes.

As of March 31, 2006, we had an aggregate of $1.4 million in outstanding capital lease obligations which are payable through 2009.

*Income Taxes*

As of December 31, 2005, we had approximately $170.2 million and $26 million of domestic and foreign net operating loss, or NOL, carryforwards, respectively, which either expire on various dates through 2025 or can be carried forward indefinitely. These losses are available to reduce federal and foreign taxable income, if any, in future years. These losses are also subject to review and possible adjustments by the applicable taxing authorities. In addition, the domestic operating loss carryforward amount at December 31, 2005 included approximately $71.2 million of pre-acquisition losses from our subsidiaries, Inverness Medical Nutritionals Group, Ischemia, Ostex International, Inc. and Advantage Diagnostics Corporation. The future benefit of these losses will be applied first to reduce to zero any goodwill and other noncurrent intangible assets related to the acquisitions, prior to reducing our income tax expense. Also included in our domestic NOL carryforwards at December 31, 2005 was approximately $2.6 million resulting from the exercise of employee stock options, the tax benefit of which, when recognized, will be accounted for as a credit to additional paid-in capital rather than a reduction of income tax. Furthermore, all domestic losses are subject to the Internal Revenue Service Code Section 382 limitation and may be limited in the event of certain cumulative changes in ownership interests of significant shareholders over a three-year period in excess of 50%. Section 382 imposes an annual limitation on the use of these losses to an amount equal to the value of the company at the time of the ownership change multiplied by the long term tax exempt rate. We have recorded a valuation allowance against a portion of the deferred tax assets related to our net operating losses and certain of our other deferred tax assets to reflect uncertainties that might affect the realization of such deferred tax assets, as these assets can only be realized via profitable operations.

**Off-Balance Sheet Arrangements**

We had no material off-balance sheet arrangements as of March 31, 2006.

**Contractual Obligations**

The following table summarizes our principal contractual obligations as of March 31, 2006 that have changed significantly since December 31, 2005 and the effects such obligations are expected to have on our liquidity and cash flow in future periods. Contractual obligations that were presented in our Annual Report on Form 10-K for the year ended December 31, 2005 but omitted in the table below represent those that have not changed significantly since that date.

| Contractual Obligations | Payments Due by Period Total (in thousands) | 2006 | 2007-2008 | 2009-2010 | Thereafter |
|---|---|---|---|---|---|
| Long-term debt obligations (1) | $ 257,974 | $ 2,039 | $ 105,935 | $ | $ 150,000 |
| Purchase of remaining CLONDIAG business (2) | $ 10,900 | $ 10,900 | $ | $ | $ |
| Purchase obligations other (3) | $ 40,564 | $ 40,564 | $ | $ | $ |

| | | | | | |
|---|---|---|---|---|---|
| Interest on debt (4) | $ 81,930 | $ 11,369 | $ 29,728 | $ 26,250 | $ 14,583 |
| Total | $ 391,368 | $ 64,872 | $ 135,663 | $ 26,250 | $ 164,583 |

(1) Long-term debt obligations increased by $3.5 million since December 31, 2005 primarily due to our borrowings under the lines of credit of our primary senior credit facility during the three months ended March 31, 2006.

(2) In connection with our acquisition of CLONDIAG, the acquisition agreement provides that we will purchase the remaining 32.55% of this business or before August 1, 2006 (see Note 8(b) of our accompanying consolidated financial statements).

(3) Other purchase obligations relate to inventory purchases and other operating expense commitments. Other purchase obligations increased by $4.8 million, as compared to the commitments at December 31, 2005, primarily due to our efforts to reduce our raw materials costs in our Nutritional business by executing certain bulk purchase commitments.

(4) Interest on debt includes amounts based on our $150.0 million senior subordinated notes and $20.0 million subordinated promissory notes. Amounts exclude interest on all other debt due to the variable interest rates (see Note 11 of our accompanying consolidated financial statements). Interest on debt has decreased by $3.8 million since December 31, 2005.

As of March 31, 2006, we had outstanding material contingent contractual obligations related to our acquisitions of ADC, Binax and CLONDIAG. With respect to our acquisition of ADC, the terms of the merger agreement, as amended, provide for $1.5 million of contingent consideration payable to the ADC shareholders upon the successful completion of a new product under development by June 30, 2006. With respect to Binax, the terms of the acquisition agreement provide for $11.0 million of contingent cash consideration payable to the Binax shareholders upon the successful completion of certain new product developments during the five years following the acquisition. With respect to the acquisition of CLONDIAG, the terms of the acquisition agreement provide for $8.9 million of contingent consideration, consisting of 224, 316 shares of our common stock and approximately $3.0 million of cash or stock in the event that four specified products are developed on CLONDIAG s platform technology during the three years following the acquisition date.

**Critical Accounting Policies**

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

*Revenue Recognition*

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

The majority of our revenues are derived from product sales. We recognize revenue upon title transfer of the products to third-party customers, less a reserve for estimated product returns and allowances. Determination of the reserve for estimated product returns and allowances is based on our management s analyses and judgments regarding certain conditions, as discussed below in the critical accounting policy Use of Estimates for Sales Returns and Other Allowances and Allowance for Doubtful Accounts. Should future changes in conditions prove management s conclusions and judgments on previous analyses to be incorrect, revenue recognized for any reporting period could be adversely affected.

In connection with the acquisition of the rapid diagnostics business in September 2003 and the Determine business in June 2005 from Abbott, we entered into a transition services agreement with Abbott, whereby Abbott would continue to distribute certain of the acquired products for a period of up to 18 months following each acquisition subject to certain extensions. During the transition period, we recognized revenue on sales of the products when title transferred from Abbott to third party customers.

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

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

Certain sales arrangements require us to accept product returns. From time to time, we also enter into sales incentive arrangements with our retail customers, which generally reduce the sale prices of our products. As a result, we must establish allowances for potential future product returns and claims resulting from our sales incentive arrangements against product revenue recognized in any reporting period. Calculation of these allowances requires significant judgments and estimates. When evaluating the adequacy of the sales returns and other allowances, our management analyzes historical returns, current economic trends, and

changes in customer and consumer demand and acceptance of our products. When such analysis is not available and a right of return exists the Company records revenue when the right of return is no longer applicable. Material differences in the amount and timing of our product revenue for any reporting period may result if changes in conditions arise that would require management to make different judgments or utilize different estimates.

Our total provision for sales returns and other allowances related to sales incentive arrangements amounted to $14.1 million and $13.4 million, or 10% and 13%, respectively, of product sales for the three months ended March 31, 2006 and 2005, respectively, which have been recorded against product sales to derive our net product sales.

Similarly, our management must make estimates regarding uncollectible accounts receivable balances. When evaluating the adequacy of the allowance for doubtful accounts, management analyzes specific accounts receivable balances, historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms and patterns. Our accounts receivable balance was $88.9 million and $70.5 million, net of allowances for doubtful accounts of $9.8 million and $9.7 million, as of March 31, 2006 and December 31, 2005, respectively.

*Valuation of Inventories*

We state our inventories at the lower of the actual cost to purchase or manufacture the inventory or the estimated current market value of the inventory. In addition, we periodically review the inventory quantities on hand and record a provision for excess and obsolete inventory. This provision reduces the carrying value of our inventory and is calculated based primarily upon factors such as forecasts of our customers demands, shelf lives of our products in inventory, loss of customers, manufacturing lead times and, less commonly, decisions to withdraw our products from the market. Evaluating these factors, particularly forecasting our customers demands, requires management to make assumptions and estimates. Actual product sales may prove our forecasts to be inaccurate, in which case we may have underestimated or overestimated the provision required for excess and obsolete inventory. If, in future periods, our inventory is determined to be overvalued, we would be required to recognize the excess value as a charge to our cost of sales at the time of such determination. Likewise, if, in future periods, our inventory is determined to be undervalued, we would have over-reported our cost of sales, or understated our earnings, at the time we recorded the excess and obsolete provision. Our inventory balance was $69.5 million and $71.2 million, net of a provision for excess and obsolete inventory of $7.5 million and $7.7 million, as of March 31, 2006 and December 31, 2005, respectively.

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

Our long-lived assets include (1) property, plant and equipment, (2) goodwill and (3) other intangible assets. As of March 31, 2006, the balances of property, plant and equipment, goodwill and other intangible assets, net of accumulated depreciation and amortization, were $75.1 million, $372.7 million and $234.4 million, respectively.

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

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

shorter estimated useful lives are more appropriate. In that event, we will be required to record additional depreciation and amortization in future periods, which will reduce our earnings.



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Valuation of Goodwill

We have goodwill balances related to our consumer diagnostics and professional diagnostics (which includes cardiology) reporting units, which amounted to $85.3 million and $287.4 million, respectively, as of March 31, 2006. As of September 30, 2005, we performed our annual impairment review on the carrying values of such goodwill using the discounted cash flows approach. Based upon this review, we do not believe that the goodwill related to our consumer diagnostics and professional diagnostics reporting units were impaired. Because future cash flows and operating results used in the impairment review are based on management s projections and assumptions, future events can cause such projections to differ from those used at September 30, 2005, which could lead to significant impairment charges of goodwill in the future. No events or circumstances have occurred since our review as of September 30, 2005, that would require us to reassess whether the carrying values of our goodwill have been impaired.

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

Factors we generally consider important which could trigger an impairment review on the carrying value of other long-lived tangible and intangible assets include the following: (1) significant underperformance relative to expected historical or projected future operating results; (2) significant changes in the manner of our use of acquired assets or the strategy for our overall business; (3) underutilization of our tangible assets; (4) discontinuance of product lines by ourselves or our customers; (5) significant negative industry or economic trends; (6) significant decline in our stock price for a sustained period; (7) significant decline in our market capitalization relative to net book value; and (8) goodwill impairment identified during an impairment review under SFAS No. 142. Although we believe that the carrying value of our long-lived tangible and intangible assets was realizable as of March 31, 2006, future events could cause us to conclude otherwise.

*Stock-Based Compensation*

As of January 1, 2006, we account for stock-based compensation in accordance with SFAS No. 123-R, *Share-Based Payment.* Under the fair value recognition provisions of this statement, share-based compensation cost is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. Determining the fair value of share-based awards at the grant date requires judgment, including estimating our stock price volatility and employee stock option exercise behaviors. If actual results differ significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted.

Our expected volatility is based upon the historical volatility of our stock. We have chosen to utilize the simplified method to calculate the expected life of options which averages an award s weighted average vesting period and its contractual term. As stock-based compensation expense is recognized in our consolidated statement of operations is based on awards ultimately expected to vest, the amount of expense has been reduced for estimated forfeitures. SFAS No. 123-R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. If factors change and we employ different assumptions in the application of SFAS No.123-R, the compensation expense that we record in future periods may differ significantly from what we have recorded in the current period.

*Accounting for Income Taxes*

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

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We have recorded a valuation allowance of $96.7 million as of December 31, 2005 due to uncertainties related to the future benefits, if any, from our deferred tax assets related primarily to our U.S. businesses and certain foreign net operating losses and tax credits. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to establish an additional valuation allowance or reduce our current valuation allowance which could materially impact our tax provision.

In accordance with SFAS No. 109, *Accounting for Income Taxes*, and SFAS No. 5, *Accounting for Contingencies*, we established reserves for tax contingencies that reflect our best estimate of the transactions and deductions that we may be unable to sustain or that

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we could be willing to concede as part of a broader tax settlement. We are currently undergoing routine tax examinations by various state and foreign jurisdictions. Tax authorities periodically challenge certain transactions and deductions we reported on our income tax returns. We do not expect the outcome of these examinations, either individually or in the aggregate, to have a material adverse effect on our financial position, results of operations, or cash flows.

It has been our company s practice to permanently reinvest all foreign earnings into foreign operations and we currently expect to continue to reinvest foreign earnings permanently into our foreign operations. Should we plan to repatriate any foreign earnings in the future, we will be required to establish an income tax expense and related tax liability on such earnings.

*Loss Contingencies*

Due to the nature of our business, we may from time to time be subject to commercial disputes, consumer product claims or various other lawsuits arising in the ordinary course of our business, and we expect this will continue to be the case in the future. These lawsuits generally seek damages, sometimes in substantial amounts, for commercial or personal injuries allegedly suffered and can include claims for punitive or other special damages. In addition, we aggressively defend our patent and other intellectual property rights. This often involves bringing infringement or other commercial claims against third parties, which can be expensive and can results in counterclaims against us. We are currently not a party to any material legal proceedings.

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

**Recently Issued Accounting Standards**

In February 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS No. 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 also clarifies and amends certain other provisions of SFAS No. 133 and SFAS No. 140. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided the Company has not yet issued financial statements, including for interim periods, for that fiscal year. We do not expect the adoption of SFAS No. 155 to have a material impact on our financial position, results of operations or cash flows.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140.* SFAS No. 156 requires that all separately recognized servicing rights be initially measured at fair value, if practicable. In addition, this Statement permits an entity to choose between two measurement methods (amortization method or fair value measurement method) for each class of separately recognized servicing assets and liabilities. This new accounting standard is effective January 1, 2007. The adoption of SFAS No. 156 is not expected to have an impact on our financial position, results of operations or cash flows.

**Recently Adopted Accounting Standards**

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs - an amendment of ARB No. 43, Chapter 4*. SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage). In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on normal capacity of production facilities. As required by SFAS No. 151, we adopted this new accounting standard on January 1, 2006. The adoption of SFAS No. 151 did not have a material impact on our financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123-R, *Share-Based Payment,* which addresses the accounting for transactions in which a company receives employee services in exchange for (a) equity instruments of the company or (b) liabilities that are based on the fair value of the company s equity instruments or that may be settled by the issuance of such equity instruments. Under the original guidance of SFAS No. 123-R, we were to adopt the statement s provisions for the interim period beginning after June 15, 2005. However, in April 2005, as a result of an action by the Securities and Exchange Commission, companies were allowed to adopt the provisions of SFAS No. 123-R at the beginning of their fiscal year that begins after June 15, 2005. Consequently, we adopted SFAS No. 123-R on January 1, 2006. See Note 4 in our

accompanying consolidated financial statements for further discussion.



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In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections,* which replaces APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. The statement requires a voluntary change in accounting principle be applied retrospectively to all prior period financial statements so that those financial statements are presented as if the current accounting principle had always been applied. APB Opinion No. 20 previously required most voluntary changes in accounting principle to be recognized by including in net income of the period of change the cumulative effect of changing to the new accounting principle. In addition, SFAS No. 154 carries forward, without change, the guidance contained in APB Opinion No. 20 for reporting a correction of an error in previously issued financial statements and a change in accounting estimate. SFAS No. 154 was effective for accounting changes and corrections of errors made after January 1, 2006. The adoption of SFAS No. 154 had no impact on our financial statements.

**SPECIAL STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. You can identify these statements by forward-looking words such as may, could, should, would, intend, will, expect, anticipate, believe, estimate, continue or similar words. You should read statements that contain these w carefully because they discuss our future expectations, contain projections of our future results of operations or of our financial condition or state other forward-looking information. There may be events in the future that we are not able to predict accurately or control and that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. We caution investors that all forward-looking statements involve risks and uncertainties, and actual results may differ materially from those we discuss in this report. These differences may be the result of various factors, including those factors described in Part I, Item 1A, Risk Factors, of our Annual Report on Form 10-K for the fiscal year ending December 31, 2005 and other risk factors identified herein or from time to time in our periodic filings with the SEC. Some important factors that could cause our actual results to differ materially from those projected in any such forward-looking statements are as follows:

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

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

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

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

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

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

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

- our ability to comply with regulatory requirements, including the outcome of the SEC s ongoing investigation into the revenue recognition issues at our Wampole subsidiary disclosed in June 2005 and the ongoing inquiry by the

Federal Trade Commission into our acquisition of certain assets from Acon Laboratories.

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

- the impact of business combinations and organizational restructurings consistent with evolving business strategies;



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- our ability to satisfy the financial covenants and other conditions contained in the agreements governing our indebtedness;

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

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

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

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

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

**Interest Rate Risk**

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

Our investing strategy, to manage interest rate exposure, is to invest in short-term, highly liquid investments. Our investment policy also requires investment in approved instruments with an initial maximum allowable maturity of eighteen months and an average maturity of our portfolio that should not exceed six months, with at least $500,000 cash available at all times. Currently, our short-term investments are in money market funds with original maturities of 90 days or less. At March 31, 2006, our short-term investments approximated market value.

At March 31, 2006, we had revolving lines of credit available to us of up to $155.0 million in the aggregate under our primary senior credit facility, against which $86.0 million was outstanding. We may repay any borrowings under the revolving lines of credit at any time but in no event later than March 31, 2008. Borrowings under the revolving lines of credit bear interest at either (i) the London Interbank Offered Rate, or LIBOR, as defined in the credit agreement, plus applicable margins or, at our option, (ii) a floating Index Rate, as defined in the agreement, plus applicable margins. Applicable margins if we choose to use the LIBOR or the Index Rate can range from 2.75% to 3.75% or 1.50% to 2.50%, respectively, depending on the quarterly adjustments that are based on our consolidated financial performance.

As of March 31, 2006, the LIBOR and Index rates applicable under our primary senior credit facility for the revolving lines of credit were 8.58% and 10.25%, respectively, and for the U.S. term loan were 8.83% and 10.5%, respectively. Assuming no changes in our leverage ratio, which would affect the margin of the interest rate under the senior credit agreement, the effect of interest rate fluctuations on outstanding borrowings under the revolving lines of credit as of March 31, 2006 over the next twelve months is quantified and summarized as follows (in thousands):

| | Interest Expense Increase |
|---|---|
| Interest rates increase by 1 percentage point | $ 860 |
| Interest rates increase by 2 percentage points | $ 1,720 |

**Foreign Currency Risk**

We face exposure to movements in foreign currency exchange rates whenever we, or any of our subsidiaries, enter into transactions with third parties that are denominated in currencies other than our, or its, functional currency. Intercompany transactions between entities that use different functional currencies also expose us to foreign currency risk. During the three months ended March 31, 2006, the net impact of foreign currency changes on transactions was a loss of $1.6 million. Generally, we do not use derivative financial instruments or other financial instruments with original maturities in excess of three months to hedge such economic exposures.



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Gross margins of products we manufacture at our European plants and sell in U.S. Dollar are also affected by foreign currency exchange rate movements. Our gross margin on total net product sales was 39.6% for the three months ended March 31, 2006. If the U.S. Dollar had been stronger by 1%, 5% or 10%, compared to the actual rates during the three months ended March 31, 2006, our gross margin on total net product sales would have been 39.7%, 40.2% and 40.7%, respectively.

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

| If, during the three months ended March 31, 2006, the U.S. dollar was stronger by: | Approximate decrease in net revenue | Approximate decrease in net loss |
|---|---|---|
| 1% | $ 598 | $ 33 |
| 5% | $ 2,992 | $ 164 |
| 10% | $ 5,983 | $ 329 |

**ITEM 4.** **CONTROLS AND PROCEDURES**

*Evaluation of Disclosure Controls and Procedures*

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

*Changes in Internal Control over Financial Reporting*

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

**PART II - OTHER INFORMATION**

**ITEM 1A.** RISK FACTORS

As we disclosed in our current report on Form 8-K filed on April 5, 2006, the Federal Trade Commission, or the FTC, has opened a preliminary, non-public investigation into our acquisition of the business being acquired from ACON Laboratories to determine whether this acquisition may be anticompetitive. We cannot predict what the outcome of this investigation will be. The FTC generally has the power to commence administrative or federal court proceedings seeking injunctive relief or divestiture of assets. In the event that an order were to be issued requiring divestiture of significant assets or imposing other injunctive relief, our business, financial condition and results of operations could be materially adversely affected.

Otherwise, there have been no material changes from the Risk Factors previously disclosed in Part I, Item 1A, Risk Factors, of our Annual Report on Form 10-K for the fiscal year ending December 31, 2005.

**ITEM 2.** UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On January 6, 2006, we issued 40,000 shares of common stock upon the exercise of warrants, for aggregate proceeds to us of $436,000, pursuant to an exemption afforded by Section 4(2) of the Securities Act of 1933, as amended.

On January 16, 2006, we issued 22,748 shares of common stock upon the exercise of warrants, for aggregate proceeds to us of $363,442, pursuant to an exemption afforded by Section 4(2) of the Securities Act of 1933, as amended.

**ITEM 6.** **EXHIBITS**

**Exhibits:**

| Exhibit No. | Description |
|---|---|
| 2.1 | Acquisition Agreement, dated February 24, 2006, by and among Inverness Medical Innovations, Inc., ACON Laboratories, Inc., AZURE Institute, Inc., LBI, Inc., Oakville Hong Kong Co., Ltd., ACON Biotech (Hangzhou) Co., Ltd. and Karsson Overseas Ltd. (incorporated by reference to Exhibit 99.1 to the Company s Current Report on Form 8-K, event date February 24, 2006, filed on February 24, 2006). |
| 2.2 | Share Purchase Agreement, dated February 28, 2006, by and between Inverness Medical Switzerland Gmbh, Inverness Medical Innovations, Inc., CLONDIAG Beteiligungs-Gesellschaft GmbH, Eugen Ermantraut, Dr. Stefan Wölfl, Dr. Torsten Schulz, Prof. Dr. Albert Hinnen, Karl Fusseis, Prof. Dr. Michael Köhler and Thomas Ellinger (incorporated by reference to Exhibit 2.9 to the Company s Annual Report on Form 10-K filed on March 15, 2006). |
| 10.1 | Investor Rights Agreement, dated March 31, 2006, by and among Inverness Medical Innovations, Inc., Ron Zwanziger, ACON Laboratories, Inc., AZURE Institute, Inc., LBI, Inc., Oakville Hong Kong Co., Ltd., ACON Biotech (Hangzhou) Co., Ltd., Karsson Overseas Ltd., Manfield Top Worldwide Ltd., Overseas Square Ltd., Jixun Lin and Feng Lin (incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K, event date March 31, 2006, filed on April 5, 2006). |
| 10.2 | Second Territory Letter Agreement, dated March 31, 2006, by and among Inverness Medical Innovations, Inc., ACON Laboratories, Inc., AZURE Institute, Inc., LBI, Inc., Oakville Hong Kong Co., Ltd., ACON Biotech (Hangzhou) Co., Ltd., Karsson Overseas Ltd., Jixun Lin and Feng Lin (incorporated by reference to Exhibit 10.2 to the Company s Current Report on Form 8-K, event date March 31, 2006, filed on April 5, 2006). |
| 10.3 | Fourth Amendment and Consent to Third Amended and Restated Credit Agreement, dated as of February 27, 2006, to the Third Amended and Restated Credit Agreement, dated as of June 30, 2005, by and among General Electric Capital Corporation, as Agent, Inverness Medical Innovations, Inc., Wampole Laboratories, LLC and Inverness Medical (UK) Holdings Limited, as borrowers, the other Credit Parties signatory thereto, Merrill Lynch Capital, a division of Merrill Lynch Business Financial Services Inc., as documentation agent, a co-syndication agent and lender, UBS Securities LLC, as co-syndication agent, and the lenders signatory thereto from time to time (incorporated by reference to Exhibit 10.36 to the Company s Annual Report on Form 10-K filed on March 15, 2006). |
| 10.4 | Fifth Amendment and Consent to Third Amended and Restated Credit Agreement, dated as of March 31, 2006, to the Third Amended and Restated Credit Agreement, dated as of June 30, 2005 (as amended, supplemented or otherwise modified from time to time), by and among General Electric Capital Corporation, as Agent, Inverness Medical Innovations, Inc., Wampole Laboratories, LLC and Inverness Medical (UK) Holdings Limited, as Borrowers, the other Credit Parties signatory thereto, Merrill Lynch Capital, a division of Merrill Lynch Business Financial Services Inc., as documentation agent, co-syndication agent and lender, UBS Securities LLC, as co-syndication agent, and the Lenders signatory thereto from time to time. (incorporated by reference to Exhibit 10.3 to the Company s Current Report on Form 8-K, event date March 31, 2006, filed on April 5, 2006). |
| 10.5 | Form of Stock Purchase Agreement, dated February 3, 2006, between the Company and the Investor named therein (incorporated by reference to Exhibit 10.18 to the Company s Annual Report on Form 10-K filed on March 15, 2006). |
| *31.1 | Certification by Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| *31.2 | Certification by Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| *32.1 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

* filed herewith

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**SIGNATURE**

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

INVERNESS MEDICAL INNOVATIONS, INC.

Date: May 9, 2006

/s/ CHRISTOPHER J. LINDOP
Christopher J. Lindop
Chief Financial Officer and an authorized officer