DIGIRAD CORP
Form 10-Q
May 07, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 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, 2007

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission file number: 000-50789

Digirad Corporation

(Exact name of registrant as specified in its charter)

Delaware	**33-0145723**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
13950 Stowe Drive, Poway, CA	**92064**
(Address of Principal Executive Offices)	**(Zip Code)**

(858) 726-1600

(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 ¨

Indicate by check mark whether registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act.)

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

Indicate by check mark whether registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes x No

As of April 23, 2007, the registrant had 18,817,951 shares of Common Stock ($0.0001 par value) outstanding.

DIGIRAD CORPORATION

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Digirad Corporation

Consolidated Balance Sheets

(In thousands, except par value amounts)

	March 31, 2007 (Unaudited)	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 9,711	$ 10,070
Securities available-for-sale	30,054	34,256
Accounts receivable, net	8,836	7,534
Inventories, net	6,801	5,860
Other current assets	1,505	1,499
Total current assets	56,907	59,219
Property and equipment, net	10,689	9,570
Intangibles, net	422	428
Restricted cash	60	60
Total assets	$ 68,078	$ 69,277
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 2,029	$ 2,643
Accrued compensation	2,497	3,650
Accrued warranty	993	788
Other accrued liabilities	3,351	3,306
Deferred revenue	2,721	2,775
Current portion of long-term debt	294	269
Total current liabilities	11,885	13,431
Long-term debt, net of current portion	41	99
Deferred rent	285	302
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.0001 par value: 10,000 shares authorized at March 31, 2007 and December 31, 2006; no shares issued or outstanding at March 31, 2007 and December 31, 2006		
Common stock, $0.0001 par value: 80,000 shares authorized at March 31, 2007 and December 31, 2006; 18,818 and 18,795 shares issued and outstanding at March 31, 2007 and December 31, 2006, respectively	2	2
Additional paid-in capital	151,817	151,539
Accumulated other comprehensive loss	(20)	(91)
Accumulated deficit	(95,932)	(96,005)
Total stockholders equity	55,867	55,445
Total liabilities and stockholders equity	$ 68,078	$ 69,277

See accompanying notes.

Digirad Corporation

Consolidated Statements of Operations

(In thousands, except per share amounts)

(Unaudited)

		Three months ended March 31, 2007	2006
Revenues:			
DIS		$ 12,197	$ 13,217
Product		5,341	5,738
Total revenues		17,538	18,955
Cost of revenues:			
DIS		8,938	10,432
Product		3,158	4,130
Total cost of revenues		12,096	14,562
Gross profit		5,442	4,393
Operating expenses:			
Research and development		782	1,096
Sales and marketing		2,098	2,459
General and administrative		2,978	4,138
Total operating expenses		5,858	7,693
Loss from operations		(416)	(3,300)
Other income (expense):			
Interest income		475	522
Interest expense		(11)	(26)
Other		26	
Total other income		490	496
Net income (loss)		$ 74	$ (2,804)
Net income (loss) per common share	basic and diluted	$ 0.00	$ (0.15)
Weighted average shares outstanding	basic	18,815	18,710
Weighted average shares outstanding	diluted	19,200	18,710

See accompanying notes.

Digirad Corporation

Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Three months ended March 31, 2007	2006
Operating activities		
Net income (loss)	$ 74	$ (2,804)
Adjustments to reconcile net income (loss) to net cash used by operating activities:		
Depreciation	855	1,335
Loss on disposal of assets	19	
Amortization of premium on securities available-for-sale	22	56
Amortization and write-off of intangibles	6	14
Stock-based compensation	267	476
Changes in operating assets and liabilities:		
Accounts receivable	(1,302)	(894)
Inventories	(941)	999
Other assets	(6)	130
Accounts payable	(614)	413
Accrued compensation	(1,153)	(160)
Accrued warranty, deferred rent and other accrued liabilities	233	(560)
Deferred revenue	(54)	11
Net cash used by operating activities	(2,594)	(984)
Investing activities		
Purchases of securities available-for-sale	(2,750)	(4,749)
Maturities of securities available-for-sale	7,000	8,200
Purchases of property and equipment	(1,993)	(1,353)
Patents and other assets		(65)
Net cash provided by investing activities	2,257	2,033
Financing activities		
Issuances of common stock	11	18
Proceeds from capital lease financing	37	
Repayment of obligations under capital leases	(70)	(243)
Net cash used by financing activities	(22)	(225)
Net decrease (increase) in cash and cash equivalents	(359)	824
Cash and cash equivalents at beginning of period	10,070	16,303
Cash and cash equivalents at end of period	$ 9,711	$ 17,127

See accompanying notes.

DIGIRAD CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

1. Interim Financial Information

Organization and Business

Digirad Corporation (Digirad), a Delaware corporation, is a provider of cardiovascular imaging services and solid-state nuclear medicine imaging products to physician offices, hospitals and imaging centers. Digirad has two reportable segments, Digirad Imaging Solutions (DIS) and Product. Through DIS, we provide in-office services to physicians, offering certified personnel, required licensure, an imaging system and other support and supplies for the performance of nuclear imaging procedures under the supervision of our physician customers. DIS physician customers enter into annual lease contracts for imaging services delivered on a per-day basis. Our Product segment sells solid-state gamma cameras and provides camera service and maintenance contracts to physician offices, hospitals, and imaging centers primarily in the United States.

Basis of Presentation

We have prepared the accompanying unaudited consolidated financial statements in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and disclosures required by generally accepted accounting principles for complete financial statements. In the opinion of our management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Intercompany accounts have been eliminated in consolidation. Operating results for the three months ended March 31, 2007 are not necessarily indicative of the results that may be expected for the entire year. For further information see our financial statements and related disclosures thereto for the year ended December 31, 2006 in our Annual Report on Form 10-K filed with the Securities and Exchange Commission.

Net Income (Loss) Per Share

We calculate net income (loss) per share in accordance with SFAS No. 128 (SFAS 128), *Earnings Per Share*. SFAS 128 requires presentation of basic earnings per share and diluted earnings per share. Basic earnings per share (EPS) is calculated by dividing the net income or loss by the weighted average number of common shares outstanding for the period, without consideration for common stock equivalents. Diluted EPS is computed by dividing the net income by the weighted average number of common shares outstanding for the period and the weighted average number of dilutive common stock equivalents such as options and warrants. Options and warrants are only included in the calculation of diluted earnings per share when their effect is dilutive.

The weighted average shares (share data in thousands) used to calculate EPS was 18,815 and 18,710 for the three months ended March 31, 2007 and 2006. The difference between the calculation of basic and diluted EPS for the three months ended March 31, 2007 is attributable to outstanding stock options. Stock options had the effect of increasing the number of shares used in the calculation (by application of the treasury stock method) by 385. Stock options of 1,354 were not included in the calculation of diluted earnings per share for the three months ended March 31, 2007 as the effect of exercising these options would have been anti-dilutive.

2. Financial Statement Details

Inventories consist of the following (in thousands):

	March 31, 2007	December 31, 2006
Raw materials	$ 2,865	$ 2,985
Work-in-progress	3,825	3,316
Finished goods	1,008	471
	7,698	6,772

Less reserves for excess and obsolete inventories	(897)	(912)
	$ 6,801	$ 5,860

Property and equipment consist of the following (in thousands):

	March 31, 2007	December 31, 2006
Machinery and equipment	$ 22,121	$ 21,276
Computers and software	3,686	3,446
Leasehold improvements	762	749
Furniture and fixtures	158	158
	26,727	25,629
Less accumulated depreciation and amortization	(16,038)	(16,059)
	$ 10,689	$ 9,570

Other accrued liabilities consist of the following (in thousands):

	March 31, 2007	December 31, 2006
Radiopharmaceuticals and consumable medical supplies	$ 820	$ 579
Professional fees	407	495
Outside services and consulting	480	454
Customer deposits	300	355
Facilities and related costs	246	279
Travel expenses	259	244
Sales and property taxes payable	165	236
Other accrued liabilities	674	664
	$ 3,351	$ 3,306

3. Warranty

We provide a warranty on certain of our products and accrue the estimated cost at the time revenue is recorded. Warranty expense is charged to product cost of revenues. The majority of all warranty periods are 12 months before customer-sponsored maintenance begins. Warranty reserves are established based on historical experience with failure rates and repair costs and the number of gamma cameras covered by warranty. Warranty reserves are depleted as gamma cameras are repaired. The costs consist principally of materials, personnel, overhead and transportation. We review warranty reserves quarterly and, if necessary, make adjustments.

The activities in our warranty reserve are as follows (in thousands):

	Three months ended March 31, 2007	2006
Balance at beginning of period	$ 788	$ 825
Charges to cost of revenues	523	260
Applied to liability	(318)	(306)
Balance at end of period	$ 993	$ 779

4. Comprehensive Income (Loss)

Comprehensive income (loss) consists of the following components (in thousands):

	Three months ended March 31,	
	2007	2006
Net income (loss), as reported	$ 74	$ (2,804)
Unrealized gains (losses) on marketable securities	71	(43)
Comprehensive income (loss)	$ 145	$ (2,847)

5. Stock-Based Compensation

We have one stock option plan under which stock options are granted to our employees and directors. Stock options granted under this plan generally have a term of ten years from the date of grant and vest over four years. Prior to June 2004,

we were authorized to issue options under various other option plans and programs, however, no additional awards may now be made under such plans. For purposes of accounting for stock-based compensation, the fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton option pricing formula. There were no significant modifications to our share-based employee payment plans during the periods presented that resulted in any incremental compensation cost. As of March 31, 2007, $2.2 million of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under our various plans is expected to be recognized over a weighted-average period of 2.0 years.

Following is a summary of stock-based compensation costs by income statement classification (in thousands):

	Three months ended March 31,	
	2007	2006
Cost of DIS revenue	$ 25	$ 20
Cost of product revenue	26	18
Research and development	23	42
Sales and marketing	50	75
General and administrative	150	316
Total stock compensation	$ 274	$ 471

6. Segments

Our reporting segments have been determined based on the nature of the products and/or services offered to customers or the nature of their function in the organization. We evaluate performance based on the operating income contributed by each segment. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies.

Segment results are as follows (in thousands):

	Three months ended March 31,	
	2007	2006
Gross profit by segment:		
DIS	$ 3,259	$ 2,785
Product	2,183	1,608
Consolidated gross profit	$ 5,442	$ 4,393
Income (loss) from operations by segment:		
DIS	$ 123	$ (1,612)
Product	(539)	(1,688)
Consolidated loss from operations	$ (416)	$ (3,300)
Depreciation, and amortization of intangible assets by segment:		
DIS	$ 628	$ 1,038
Product	233	311
Consolidated depreciation and amortization	$ 861	$ 1,349

	As of March 31,	
	2007	2006
Identifiable assets by segment:		
DIS	$ 16,340	$ 14,764
Product	51,738	56,848

Consolidated assets	$ 68,078	$ 71,612

Although we have historically sold a small number of imaging systems internationally, foreign sales are not a significant source of our revenues for the periods presented above.

7. Commitments and Contingencies

Compliance with Laws and Regulations

We are, directly or indirectly through our clients, subject to extensive regulation by the federal government, the states and foreign countries in which we conduct business. The healthcare laws applicable to us are complex and are subject to variable interpretations. We have established a compliance program to identify any compliance issues, correct any identified issues and assist us in remaining in compliance with the applicable healthcare laws, and have instituted other safeguards intended to help prevent any violations of the laws and to remedy any situations that could give rise to violations. We can provide no assurance that these measures will be successful in preventing compliance violations and the resulting fines, penalties or damages.

Legal Matters

In the normal course of business, we have been and will likely continue to be subject to litigation or administrative proceedings incidental to our business, such as claims related to customer disputes, employment practices, wage and hour disputes, product liability, professional liability, commercial disputes, licensure restrictions or denials, and warranty or patent infringement. Responding to litigation or administrative proceedings, regardless of whether they have merit, can be expensive and disruptive to normal business operations. As litigation and the administrative proceedings are inherently uncertain, we cannot predict the outcome of such matters. We can provide no assurance that the ultimate outcome, either individually or in the aggregate, will not have a material adverse effect on our business or financial results.

8. Income Taxes

On January 1, 2007, we adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes. The adoption of FIN 48 did not impact our consolidated financial condition, results of operations or cash flows. At January 1, 2007, we had net deferred tax assets of $36.8 million. These deferred tax assets are primarily composed of federal and state tax net operating loss (NOL) carryforwards and federal and state research and development (R&D) credit carryforwards. Due to uncertainties surrounding our ability to generate future taxable income to realize these assets, a full valuation has been established to offset our net deferred tax asset. Additionally, the future utilization of our NOL and R&D credit carryforwards to offset future taxable income may be subject to a substantial annual limitation as a result of ownership changes that may have occurred previously or that could occur in the future. Until we have determined whether such an ownership change has occurred, and until the amount of any limitation becomes known, no amounts are being presented as an uncertain tax position in accordance with FIN 48. Management believes that the amount subject to limitation could be significant. Any carryforwards that will expire prior to utilization as a result of such limitations will be removed from deferred tax assets with a corresponding reduction of the valuation allowance. Due to the existence of the valuation allowance, future changes in our unrecognized tax benefits will not impact our effective tax rate.

We file income tax returns in the U.S. and in various state jurisdictions. We are no longer subject to income tax examination by tax authorities for years prior to 2003, however, our net operating loss and research and development carryforwards arising prior to that year are subject to adjustment. Our policy is to recognize interest and penalties related to income tax matters as a component of income tax expense.

9. Subsequent Event

On May 1, 2007, we acquired substantially all of the assets of Ultrascan, Inc. (Ultrascan), a leading provider of mobile ultrasound and fixed-site nuclear medicine services primarily in Georgia, in exchange for cash consideration of $7.25 million and the assumption of debt obligations totaling $1.5 million. The purchase price is subject to a working capital adjustment after the closing of the transaction. Additional consideration, payable in cash and common stock, of up to $3.85 million may be payable to the seller or its designees in the event that Ultrascan achieves certain financial milestones over the next four years.

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

The following discussion and analysis should be read in conjunction with our financial statements and notes thereto included in this report on Form 10-Q, and the audited financial statements and notes thereto as of and for the year ended December 31, 2006 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 20, 2007. Operating results are not necessarily indicative of results that may occur in future periods.

This report includes various forward-looking statements that are subject to risks and uncertainties, many of which are beyond our control. Our actual results could differ materially from those anticipated in these forward looking statements as a result of various factors, including those set forth below under the caption Risk Factors. Forward-looking statements discuss matters that are not historical facts. Forward-looking statements include, but are not limited to, discussions regarding our operating strategy, growth strategy, product development, cost savings initiatives, industry, economic and market conditions, financial condition, liquidity and capital resources and results of operations. In this report, for example, we make forward-looking statements regarding our expectations about revenue growth in DIS as we expand into new markets and continue to improve utilization rates within existing markets, growth in our ultrasound services, our efforts to obtain accreditation for our DIS hubs, the effects of changes to the Stark Law, the size and impact of potential Medicare and other third party payor reimbursement decreases, the roll-out of our multi-headed Cardius XPO camera into DIS and the value it represents to our customers, persistent pricing pressures affecting our sales of multi-headed gamma cameras, and continuing investments in research and development initiatives. Such statements include, but are not limited to, statements preceded by, followed by or that otherwise include the words believes, expects, anticipates, intends, estimates, projec can, could, may, will, would, or similar expressions. For those statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. You should not unduly rely on these forward-looking statements, which speak only as of the date on which they were made. We undertake no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless required by law.

Overview

We are a leading provider of cardiovascular imaging services and solid-state nuclear medicine imaging products to physician offices, hospitals and imaging centers. We designed and commercialized the first solid-state nuclear gamma camera for the detection of cardiovascular disease and other medical conditions. Our imaging systems are mobile as well as fixed and provide enhanced operability, improved patient comfort and, in the case of our triple-headed Cardius®-3 XPO system, shorter image acquisition time, when compared to traditional vacuum tube cameras. The cameras and accompanying equipment fit easily into floor spaces as small as seven feet by eight feet and facilitate the delivery of nuclear medicine procedures in a physician s office, an outpatient hospital setting or within multiple departments of a hospital.

First Quarter 2007 Financial Highlights

Our consolidated revenues were $17.5 million during the three months ended March 31, 2007 (2007), which represented a decrease of 7.5% over the comparable prior year period (2006) due to the decrease in revenue in both segments of our business. In DIS, revenue decreased 7.7% to $12.2 million, primarily due to DIS having phased out the delivery of stress agents. In the product business, revenue decreased 6.9% to $5.3 million. Consolidated net income for the quarter was $74,000, compared to a net loss of $2.8 million during the same period in 2006.

DIS began to phase out providing stress agents used in some imaging procedures in June 2006. As a result, we recognized no stress agent revenue in 2007 compared to $1.1 million recognized in 2006. As of March 31, 2007, our DIS segment operated in 22 states and the District of Columbia. DIS service days were unchanged at 3,461 in 2007 compared to 2006. Revenue per day was $3,524 for 2007 compared to $3,489 for 2006 (excluding the stress agent revenue we received in 2006). Our DIS gross margins in 2007 increased to 26.7% compared to 21.1% in 2006, due primarily to lower pharmaceutical costs and a reduction in depreciation expense.

As of March 31, 2007, DIS operated 82 mobile cameras compared to 80 cameras during the same period in 2006. In connection with our plan to upgrade our DIS camera fleet over the next few years, we placed 8 incremental triple-headed cameras into our DIS business in the first quarter of 2007, bringing the total number of such cameras in the fleet to 27. We continue to obtain additional hub accreditation to respond to the reimbursement requirements of some third party payors. As of March 31, 2007, we had obtained accreditation from the Intersocietal Commission for the Accreditation of Nuclear Medicine Laboratories for 28 of our DIS hub locations.

Our product business delivered 19 gamma cameras in the first quarter of 2007, an increase of one system compared to 2006. Product revenue decreased over the prior year period by $0.4 million, primarily due to a change in the mix of cameras

sold and reduced average selling prices due to continuing competitive pricing pressures. Product gross margins improved to 40.9% in 2007 compared to 28.0% during 2006, due primarily to reduced labor and overhead expenses and improved manufacturing yields. During the first quarter of 2007, we expanded our product portfolio by adding the XPO features already available on our Cardius-3 camera to the Cardius-1 and Cardius-2 cameras. Our new Cardius XPO camera series allows physicians to choose among single-, dual- and triple-head cameras to accommodate their practices speed and throughput needs, or to upgrade a single head camera to a dual or triple head configuration as their practice grows and changes. These cameras can image patients weighing up to 500 pounds and include our latest image acquisition and processing software.

Our Market

The target market for our products and services is comprised of approximately 26,000 cardiologists, the larger practices among the 130,000 internists and family practitioners, and hospitals in the United States that perform or could perform nuclear cardiac procedures. We estimate that there are approximately 8,000 internist practices with more than four internists. As of March 31, 2007, we have provided imaging services through DIS to approximately 600 physicians and physician groups, the majority of which are cardiologists, and have sold 477 cameras through our product segment.

According to IMV Medical Information, U.S. procedure volume in nuclear medicine (excluding PET studies) grew by 15% between 2002 and 2005 to an estimated 19.7 million nuclear imaging procedures in 2005, of which some 11.2 million were cardiovascular-specific procedures. The National Electrical Manufacturers Association, or NEMA, estimates that sales of general nuclear imaging equipment declined approximately 10% during 2006.

We believe our market has been negatively affected by declining reimbursement, significant pricing pressures in the product business, and continuing efforts by some third party payors to reduce health care expenditures by requiring physicians to obtain specific accreditations or certifications, or disallowing reimbursement if imaging is performed with mobile or leased cameras. A number of companies have recently begun to market mobile nuclear imaging cameras for cardiac applications, and we believe competition from local or regional companies providing mobile imaging services has increased. We expect each of these trends to continue.

Revenue Sources

We generated revenues within two primary operating segments: our DIS business and our product sales business. Through DIS, we offer a comprehensive mobile imaging services leasing program as an alternative to purchasing a gamma camera or ultrasound machine for physicians who wish to perform nuclear imaging, echocardiography, vascular ultrasound or any combination of these procedures in their offices by leasing the imaging system, certified personnel and other support required to perform imaging in the physician office. The flexibility of our products and our DIS leasing service allows physicians more control over the diagnosis and treatment of their patients in their offices and to retain revenue from procedures they would otherwise refer elsewhere. We also offer DigiTech leases to customers who own one of our nuclear gamma cameras or ultrasound machines but wish us to provide staffing and other support services. DIS leasing services are primarily provided to cardiologists and internists. Physicians enter into annual contracts for imaging services delivered on a per-day basis. Our typical lease contracts provide service coverage ranging from once per month to three times per week, adjusted for holidays and vacations. We experience some seasonality in our DIS business related to summer slowdowns (principally relating to vacations), holidays and inclement weather. Historically, the DIS results have been most negatively affected by seasonality in the third quarter.

Our product revenue results primarily from selling solid-state gamma cameras and other ancillary items, and from our camera maintenance contracts. We sell our imaging systems to physician offices, hospitals, and imaging centers primarily in the United States, although we have sold a small number of imaging systems internationally. We do not anticipate that the international market will be a significant source of revenues in the foreseeable future.

Trends and Drivers

We believe this quarter s improved net income and gross margins in both our business segments are the results of our efforts to enhance operating efficiencies, lower material costs and reduce operating expenses. We expect these trends to continue, and to reap further labor cost reductions and camera reliability improvements as we continue to upgrade our DIS mobile camera fleet. We have also commenced the delivery of mobile ultrasound imaging services, a first step in diversifying our mobile service model.

The decrease in DIS revenue is primarily attributable to the decision to stop the delivery of stress agents, which contributed approximately $1.1 million to the results in the same quarter of 2006. The increase in the number of physicians who either bought their own cameras or switched to other mobile imaging service providers during the second half of 2006 continued during the first quarter of 2007. We attribute this trend to increasing competition from local and regional companies offering mobile imaging products or services.

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We also note that there were Medicare reimbursement cuts of approximately 8.5% for 2007 as compared to 2006 for the imaging procedures most often performed by our physician customers.

In the product business, industry sources predict that the rate of decline of sales of cardiac-specific nuclear cameras will slow from an estimated 24% in 2006 to approximately 5% in 2007, and that purchases of multi-head cameras will far outpace those of single-head cameras. We believe pricing pressures persist in the cardiac-specific camera market, evidenced by the declining average selling price of nuclear cameras. We will continue to invest in research and development to improve the image quality, speed, reliability, cost structure and overall performance of our multi-headed cameras and software to counteract these pricing pressures. The hospital market has expressed a renewed interest in our general purpose single-head camera, and we expect to continue to sell more cameras into this market in 2007.

Results of Operations

The following table sets forth our results from operations, expressed as percentages of revenues for the three months ended March 31, 2007 and 2006:

	Three months ended March 31,	
	2007	**2006**
Revenues:		
DIS	69.5%	69.7%
Product	30.5	30.3
Total revenues	100.0	100.0
Total cost of revenues	69.0	76.8
Gross profit	31.0	23.2
Operating expenses:		
Research and development	4.5	5.8
Sales and marketing	12.0	13.0
General and administrative	16.9	21.8
Total operating expenses	33.4	40.6
Loss from operations	(2.4)	(17.4)
Other income (expense)	2.8	2.6
Net income (loss)	0.4%	(14.8)%

Comparison of Three Months Ended March 31, 2007 and 2006

Revenues

Consolidated. Consolidated revenue was $17.5 million for 2007, which represents a decrease of $1.4 million, or 7.5% over 2006, primarily as a result of the discontinuation of the sale of stress agents by DIS in June 2006, and a decline in product segment revenue associated with our selling a higher number of used and lower-priced cameras at a reduced average selling price. DIS and product revenue accounted for 69.5% and 30.5%, respectively, of total revenues for 2007, compared to 69.7% and 30.3%, respectively, for 2006. We expect DIS revenue to continue to represent the larger percentage of our consolidated revenue in future periods.

DIS. Our DIS revenue decreased to $12.2 million for 2007, which represents a decrease of $1.0 million, or 7.7%, over the prior year quarter. This decrease was primarily the result of our decision to discontinue the sale of stress agents in June 2006 (stress agent revenue was $1.1 million for 2006). We seek to increase our DIS revenue by broadening our services to include ultrasound imaging, penetrating existing markets and expanding into new markets. Any growth will fluctuate, however, based on seasonality stemming from physician vacations, holidays, and incleme+6nt weather and from the start up time required as we enter new geographic areas.

Product. Our product revenue decreased to $5.3 million for 2007, representing a decrease of $0.4 million, or 6.9%, over the prior year quarter. The decrease in product revenue is attributable to a decline in the average selling prices for our gamma cameras and selling more used cameras

in 2007 than in 2006.

Gross Profit

Consolidated. Consolidated gross profit was $5.4 million for 2007, representing an increase of $1.0 million or 23.9%, compared to the prior year quarter. The increase in consolidated gross profit is principally the result of our efforts to improve operational efficiencies and lower material costs as well as to improve product reliability and serviceability. Consolidated gross profit as a percentage of revenue increased to 31.0% for 2007 from 23.2% for 2006.

DIS. Cost of DIS revenue consists primarily of labor, radiopharmaceuticals, equipment depreciation, and other costs associated with the provision of services. Cost of DIS revenue decreased to $8.9 million for 2007, representing a decrease of $1.5 million, or 14.3%, over the prior year quarter, primarily a result of the decrease in revenue. DIS gross profit increased to $3.3 million for 2007, which represents an increase of $0.5 million, or 17.0%. DIS gross profit as a percentage of revenue increased to 26.7% for 2007 from 21.1% for 2006, primarily as a result of a reduction in radiopharmaceutical costs and a reduction in depreciation expense.

Product. Cost of goods sold primarily consists of materials, labor and overhead costs associated with the manufacturing and warranty of our products. Warranty costs are charged to cost of goods sold in the period our cameras are sold and are based on our historical experience with failure rates and repair costs. Cost of goods sold was $3.2 million for 2007, representing a decrease of $1.0 million, or 23.5%, compared to the prior year quarter. Product gross profit increased to $2.2 million for 2007 as compared to $1.6 million for 2006. Product gross profit as a percentage of revenue increased to 40.9% for 2007 from 28.0% for 2006. Product margin improvement is due to a reduction in material costs and an improvement in operating efficiency.

Operating Expenses

Research and Development. Research and development expenses consist primarily of costs associated with the design, development, testing, and enhancement of our products. The primary costs are salaries and fringe benefits, development material costs, facility and overhead costs, consulting fees, and non-recurring engineering costs. Research and development expenses were $0.8 million for 2007, which represents a decrease of $0.3 million, or 28.6%, over the prior year quarter. This was primarily attributable to a reduction in the number of research personnel and decreased spending on indirect materials associated with new product development. Research and development expenses were 4.5% of total revenue for 2007 compared to 5.8% for 2006. In the future, we expect to maintain our investment in research and development as we innovate and seek to improve our existing technology.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries, commissions, bonuses, recruiting costs, travel, marketing and collateral materials and trade show costs. Sales and marketing expenses were $2.1 million for 2007, representing a decrease of $0.4 million or 14.7%, over the prior year quarter, primarily as a result of a reduction in personnel and travel costs and trade show expenses. Sales and marketing expenses were 12.0% of total revenue for 2007 compared to 13.0% for 2006. We expect to increase our sales and marketing efforts as we expand into new territories and launch a marketing program for echocardiography and vascular ultrasound.

General and Administrative. General and administrative expenses consist primarily of salaries and other related costs for finance, accounting, human resources and other personnel, and legal and other professional fees and insurance. General and administrative expenses were $3.0 million for 2007, representing a decrease of $1.2 million or 28.0%, over the prior year quarter. In 2006, the cost of certain personnel was shifted from general and administrative expenses to cost of goods sold to reflect the change in the nature of their job responsibilities. Additionally, we experienced a $166,000 reduction in stock based compensation costs as well as lower legal costs, and our cost reduction efforts have resulted in a lower level of spending associated with recruiting, consulting fees, and other outside services. General and administrative expenses were 16.9% of total revenue for 2007 compared to 21.8% for 2006.

Other Income (Expense)

Other income (expense) consists primarily of interest income, net of interest and other expenses. Other income was essentially unchanged for both periods presented.

Net Income (Loss)

Our net income was $0.1 million for 2007 compared to a net loss of $2.8 million for 2006, primarily as a result of the factors described above.

Liquidity and Capital Resources

We require capital principally for debt service, capital expenditures and working capital to finance accounts receivable and inventory. Our working capital requirements vary from period to period depending on manufacturing volumes, the timing of deliveries and the payment cycles of our customers. Our capital expenditures consist primarily of DIS nuclear cameras, ultrasound machines, vans, and computer hardware and software. As of March 31, 2007, we had cash, cash equivalents and investments of $39.8 million. We currently invest our cash reserves in money market funds, high-grade auction rate securities and U.S. government or corporate debt securities. Based upon our current level of expenditures, we believe our current working capital together with cash flows from operating activities, will be adequate to meet our anticipated cash requirements for working capital, debt service and capital expenditures for at least the next 12 months.

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Net cash used in operations totaled $2.6 million for the three months ended March 31, 2007, despite positive cash flow from net income and non-cash charges (including depreciation, amortization and stock-based compensation). The cash used in operations is due to increases in both receivables and inventory and the reduction of accounts payable and accrued compensation. The increase in receivables reflects the increase in revenue activity at the end of the first quarter as compared to the previous quarter, while the increase in inventory is primarily associated with an increase in finished goods. The decrease in accounts payable reflects routine fluctuation in vendor activity and the decrease in accrued compensation is primarily associated with the payment of year end bonuses to our employees. Net cash provided by investing activities amounted to $2.3 million for the three months ended March 31, 2007, and is comprised of the cash flow from net maturities of securities available-for-sale of $4.3 million partially offset by $2.0 million of capital expenditures primarily associated with our DIS operations. Net cash used by financing activities amounted to approximately $22,000 for the three months ended March 31, 2007, and represents the repayment of capital lease obligations, net of proceeds arising from the exercise of stock options.

On May 1, 2007, we acquired substantially all of the assets of Ultrascan, Inc. (Ultrascan) in exchange for cash consideration of $7.25 million and the assumption of debt obligations totaling $1.5 million. We repaid the debt obligations at the time of the acquisition. Additional consideration, payable in cash and common stock, of up to $3.85 million may be payable to the seller or its designees in the event that Ultrascan achieves certain financial milestones over the next four years.

Critical Accounting Policies

Management s discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements which are prepared in accordance with accounting principles that are generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities, related disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. We continually evaluate our estimates and judgments, the most critical of which are those related to revenue recognition and inventory valuation. We base our estimates and judgments on historical experience and other factors that we believe to be reasonable under the circumstances. Materially different results can occur as circumstances change and additional information becomes known.

There were no significant changes during the quarter ended March 31, 2007 to the items that we disclosed as our critical accounting policies and estimates in Management s Discussion and Analysis of Financial Condition and Results of Operations in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

New accounting requirement. Effective January 1, 2007, we adopted Financial Accounting Standards Board, or FASB, Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of SFAS No. 109 , or FIN No. 48, which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN No. 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The adoption of FIN 48 did not impact our consolidated financial condition, results of operations or cash flows. We do not anticipate that the adoption of FIN No. 48 will have a material effect on our effective tax rate in future periods.

Corporate Information

As of March 31, 2007, we hold trademark registrations in the United States for the following marks: 2020tc Imager®, CardiusSST®, Digirad®, Digirad Logo®, Digirad Imaging Solutions®, FlexImaging®, Cardius®, SPECTour®, DigiServ®, DigiTech®, SPECTpak Plus® and Solidium®. We have trademark applications pending in the United States for the following marks: SeeQuanta, AcqSmart, Stasys, Cardius X-Act, and TruAcq CountBased Imaging. We have obtained and sought trademark protection for some of these listed marks in the European Community and Japan.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk due to changes in interest rates relates primarily to the increase or decrease in the amount of interest income we can earn on our investment portfolio. Our risk associated with fluctuating interest rates is limited to our investments in interest rate sensitive financial instruments. Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes. We attempt to increase the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in investment grade securities. A hypothetical 100 basis point adverse move in interest rates along the entire interest rate yield curve would not materially affect the fair value of our interest sensitive financial instruments. Changes in interest rates over time will increase or decrease our interest income.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

We maintain disclosure controls and procedures and internal controls that are designed to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures and internal controls, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable, and not absolute, assurance of achieving the desired control objectives. In reaching a reasonable level of assurance, management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures and internal controls.

As required by the Securities and Exchange Commission Rule 13a-15(e) and Rule 15d-15(e), we carried out an evaluation, under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting.

In addition, an evaluation was performed under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of any change in our internal controls over financial reporting that has occurred during our last fiscal quarter that has materially affected, or is reasonably likely to affect materially, our internal controls over financial reporting. There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In the normal course of business, we have been and will likely continue to be subject to litigation or administrative proceedings incidental to our business, such as claims related to customer disputes, employment practices, wage and hour disputes, product liability, professional liability, commercial disputes, licensure restrictions or denials, and warranty or patent infringement. Responding to litigation or administrative proceedings, regardless of whether they have merit, can be expensive and disruptive to normal business operations. As litigation and the administrative proceedings are inherently uncertain, we cannot predict the outcome of such matters. We can provide no assurance that the ultimate outcome, either individually or in the aggregate, will not have a material adverse effect on our business or financial results.

ITEM 1A. RISK FACTORS

Risks Related to Our Business and Industry

Our industry is highly competitive.

The nuclear imaging industry is highly competitive, subject to rapid change and significantly affected by new product introductions and market activities of other industry participants. Our primary competitors with respect to nuclear imaging systems include Philips Medical Systems, General Electric Healthcare, Siemens Medical Systems and Toshiba Medical Systems. All of these competitors offer a full line of imaging cameras for each diagnostic imaging technology, including x-ray, magnetic resonance imaging, computerized tomography, ultrasound and nuclear medicine, as well as hybrid modalities that combine, for example, the technologies of positron emission tomography, or PET, with computed tomography, or CT. Many of our competitors and potential competitors enjoy significant advantages over us, including significantly greater name recognition and financial, technical, service and marketing resources; established relationships with healthcare professionals, customers and third-party payors; established distribution networks; technical features our current products do not possess; multiple product lines and the ability to offer rebates or bundle products to offer discounts or incentives; and greater resources for product development, sales and marketing.

Certain medical device companies are developing solid-state cameras that may compete with our product offerings. A privately-held company, Gamma Medica, is marketing a solid-state gamma camera for breast imaging. A second company, Spectrum Dynamics, has demonstrated a proof-of-concept solid-state gamma camera that we believe it may market in the cardiac segment, and a third company, Spectrica, is marketing a

mobile cardiac camera based on vacuum tube technology. We anticipate that additional companies will dedicate significant resources to developing competing products and services that may demonstrate better image quality, ease of use or mobility than our imaging systems. If we are unable to compete effectively against our existing and future competitors, our sales will decline and our business will be harmed.

In providing DIS lease services, we compete against small businesses employing traditional vacuum tube cameras that cannot be moved in and out of physician offices. We also compete against physicians and companies that use Digirad cameras in local, regional and national mobile imaging businesses, some of which have the advantage of a lower cost structure, and competition from these mobile operations is likely to increase. In addition, we compete against imaging centers that install nuclear gamma cameras and make them available to referring physicians in their geographic vicinity. If these competitors are able to win significant portions of our business, our sales will decline and our business will be harmed.

The competitive nature of the nuclear imaging industry has affected the volume of both our camera sales and our leasing services, and the pricing of our gamma cameras. We anticipate that these pressures will continue.

If the market for nuclear imaging cameras continues to decrease, or if we are not successful in expanding our market share or product and service offerings, our revenues will decline and our business will be harmed.

The National Electrical Manufacturers Association, or NEMA, estimates that sales of nuclear imaging equipment, excluding maintenance revenue, declined approximately 10% in 2006. We believe this decline may be attributable to concerns about reimbursement changes and the increasing adoption of alternative imaging modalities, such as magnetic resonance imaging, computerized tomography, positron emission tomography, and hybrids among these modalities. We believe our market has been negatively affected by declining reimbursement, significant pricing pressures in the product business, increased competition in the mobile imaging business and increasing reimbursement restrictions. We expect each of these trends to continue.

If these trends continue and we are unable to offset their effects on our business by expanding our market share or successfully introducing alternative products and services, our business will be significantly harmed.

Changes in coverage and reimbursement policies of third-party payors may adversely impact our ability to market and sell our products and services.

Private third-party payors continue to act to contain or reduce healthcare costs through various means, including the movement to managed care systems where healthcare providers contract to provide comprehensive healthcare for a fixed fee per patient. A number of third party payors in geographic locations currently served by us issued guidelines preventing our physician customers from obtaining reimbursement for procedures they perform unless they own or lease our cameras on a full time basis. These and other payors are also requiring physicians to be accredited by either the Intersocietal Commission for the Accreditation of Nuclear Medicine Laboratories (ICANL) or by the American College of Radiology, and to meet certain other privileging standards. Some of these privileging standards also exclude physicians who are not radiologists or cardiologists from obtaining reimbursements for nuclear imaging procedures. An increasing number of our DIS customers are non-cardiologists who would not currently meet the certifications required by payors in certain geographic areas. We have obtained accreditation from the Intersocietal Commission for the Accreditation of Nuclear Medicine Laboratories for 28 of our hub locations to address certification requirements, but we cannot assure you that we will be successful in obtaining additional certifications, or that obtaining them will satisfy the requirements of these payors. We also cannot assure you that these third party payor guidelines will be changed, or that they will not be adopted by other third party payors, including Medicaid and Medicare. These continued efforts to restrict reimbursement have resulted in the denial of reimbursement in some instances. An increase in such denials will negatively affect our DIS business and product sales.

If we acquire new or complementary businesses, products or technologies instead of developing them ourselves, we may be unable to complete those acquisitions or to successfully integrate them in a cost-effective and non-disruptive manner.

Our success depends on our ability to continually enhance and broaden our product and service offerings in response to changing customer demands, competitive pressures and technologies. We may choose to pursue collaborations or acquisitions instead of developing businesses, products or technologies ourselves. We cannot assure you, however, that we would be able to successfully complete any acquisition or that we would be able to successfully integrate any acquired business, product or technology into our company in a cost-effective and non-disruptive manner. Furthermore, there is no certainty that we would be able to attract, hire or retain key employees associated with any acquired businesses, products or technologies.

Integrating any acquired businesses, products or technologies could be expensive and time consuming, disrupt our ongoing business and divert the attention and resources of our management. If we are unable to integrate any acquired businesses, products or technologies effectively, our business will likely suffer. Additionally, any amortization of assets or charges resulting from the costs of acquisitions could negatively impact our operating results.

Failure to attract qualified managers, engineers and imaging technologists, or high employee attrition rates, could limit our growth and adversely affect our business.

Our success is dependent on the efforts of our key executives and technical, sales and managerial personnel and our ability to retain them. Losing any one or more of these individuals could place a significant strain on our remaining management team and we may have difficulty replacing any of these individuals. Our future growth and ability to generate profits will depend in part upon our ability to identify, hire and retain nuclear imaging technologists, certified cardiographic technicians, nurses, radiation safety officers, engineers, management, sales personnel and other highly skilled personnel.

Hiring qualified management and technical personnel will be difficult due to the limited number of qualified candidates. Competition for these types of employees, particularly nuclear imaging technologists and engineers, is intense in the medical imaging field. Failure to attract, hire and retain key personnel could have an adverse effect on our business, financial condition and results of operations. For the quarter ended March 31, 2007, we experienced an 11.1% rate of employee turnover for the combined service and product segments. If we are unable to improve upon this metric, our business and financial condition may continue to be adversely affected.

Our imaging systems and DIS services may become obsolete, and we may not be able to timely develop new products, product enhancements or services that will be accepted by the market.

Our nuclear imaging systems and DIS services may become obsolete or unmarketable if other products or services utilizing new technologies or the development of hybrid imaging modalities are introduced by our competitors or new industry standards emerge. We cannot assure you that any future products and enhancements will be accepted by the market. To be successful, we will need to enhance our products or services and to design, develop and market new products that successfully respond to competitive developments, all of which may be expensive and time consuming.

The success of any new product offering or enhancement to an existing product will depend on several factors, including our ability to properly identify and anticipate physician and patient needs; develop new products or enhancements in a timely manner; obtain the necessary regulatory approvals or clearances for new products or product enhancements in a timely manner; provide adequate training to users of our products; price our products competitively; obtain required licensure; continue to offer cost-competitive products and services despite increasing reimbursement restrictions and pricing pressures; comply with changing or new regulatory requirements; and develop an effective marketing, sales and distribution network.

If we are unable to meet these requirements, our business, financial condition and results of operations will suffer. In addition, even if our customers acquire new products, services or product enhancements, the revenues from such sales may not be sufficient to offset the significant costs associated with developing and offering such products, services or enhancements to customers. In addition, any announcements of new products, services or enhancements may cause customers to decline or cancel their purchasing decisions in anticipation of replacements.

If we are unable to expand our DIS business, our growth rates could be significantly diminished and our business could be materially harmed.

We plan to grow our DIS business by expanding into new states, adding new hub locations in states in which we currently operate and increasing existing hub utilization by adding physician customers and routes. Our progress in expanding into new geographies has been slower than anticipated, our hub utilization and customer density in some geographies have decreased, and we cannot assure you that we will be able to sell our leasing services at the rates we anticipate, or that physicians or hospitals in these new markets will accept our imaging products or services. Our expansion into additional markets is subject to inherent risks, including those associated with compliance with applicable state laws and regulations. We may find the laws of states in which we do not currently operate preclude us from operating our DIS business, or require us to change the structure in which we operate our DIS business in such states. Our inability to expand into new markets for any of these reasons could diminish our prospects for growth and profitability.

Because our imaging systems and DIS services are not widely diversified, a decrease in sales of our products and leasing services could seriously harm our business.

Our current product and service offerings consist primarily of our line of gamma cameras, including our Cardius-1, Cardius-2, and Cardius-3 XPO Series, 2020*tc* Imager and SPECTpak PLUS camera systems, all designed for use in the nuclear imaging market segment. In addition, our DIS mobile imaging leasing service utilizes our own line of cameras and at present is focused nearly exclusively on nuclear cardiology. As such, our line of products and services is not as diversified as those of some of our competitors. If the sales of our products or leasing services decline, our business would be seriously harmed, and it would likely be difficult for us to sustain our business while seeking to develop new types of products or services or other markets for our existing products and services. In addition, because our technical know-how and intellectual property have limited applications, we may be unable to leverage these assets to diversify our products and services or to develop other products

or sources of revenue outside of the nuclear imaging market.

If we experience problems with the technologies used in our imaging systems or if delivery of our DIS services is delayed, public perception of our products and service offerings could be harmed and we may lose customers and revenue.

We have experienced some reliability issues with our camera detector heads and other parts of our imaging systems, and some of the cameras in our DIS fleet are more than four years old. Although we have embarked on a program to upgrade our fleet over a three year horizon, as the period of use of our cameras increases, other significant defects may occur. Additionally, physicians rely on our DIS services to provide nuclear imaging procedures to their patients on the dates and at the times they have leased. Many factors could prevent us from delivering our DIS services on a timely basis, including equipment failures, unanticipated problems with our mobile Cardius-3XPO camera, weather and the availability of staffing, transportation and necessary supplies. If we are unable to provide physicians or hospitals our DIS services in a timely and efficient manner, our business would be harmed.

We are subject to the financial risks associated with providing services through our DIS business.

There are numerous risks associated with any leasing arrangement, including the possibility that physicians may fail to pay us because of general economic and business conditions, the availability of reimbursement or other reasons. In addition, a number of our DIS customers decide to purchase their own cameras, made by us or by one of our competitors, rather than continue to use our DIS leasing service. If purchases by DIS customers of cameras made by our competitors were to increase, our business and financial condition could be adversely affected. In addition, the number of customers who have canceled or failed to renew their lease contracts recently has increased, and our business may be significantly harmed if this trend continues.

Our manufacturing operations are highly dependent upon third-party suppliers, making us vulnerable to supply problems and price fluctuations, which could harm our business.

We rely on a limited number of third parties to manufacture and supply certain of the key components of our products. While many of the components used in our products are available from multiple sources, we obtain some components from single sources, and alternative sources for them may not be readily available. For example, key components of the detector heads and the processing and control software utilized in our gamma cameras are manufactured or supplied by a single source. If we were unable to obtain these components, our ability to build gamma cameras could be materially affected, and we could experience delays in the production of our gamma cameras for an extended period of time that could cause the loss of customers and revenue.

We have limited marketing, sales and distribution capabilities.

Our future revenue growth will depend in large part on our success in maintaining and expanding our marketing, sales and distribution channels, which is an expensive and time-consuming process. We are highly dependent upon the efforts of our sales force and third-party distributors to increase our revenue. We use three independent distributors in the United States and an independent, international sales distributor to market, sell and distribute our products and services. Our domestic third-party distributors are generally permitted to market, sell and distribute competing imaging products that are used or refurbished and meet specified age requirements. Our international distributors are prohibited from promoting or distributing any other gamma camera product, but not prohibited from offering competing services. We face intense competition for qualified sales employees and may be unable to hire, train, manage and retain such personnel, which could adversely affect our ability to maintain and expand our marketing, sales and distribution network. If we are unable to maintain and expand our direct and third-party marketing, sales and distribution networks, we may be unable to sell enough of our products and imaging services for our business to be profitable and our financial condition and results of operations will likely suffer.

We are exposed to risks relating to product liability, product recalls, property damage and personal injury and death for which insurance coverage is expensive, limited and potentially inadequate, and our business may be negatively affected by insufficiently insured claims and increased insurance costs.

Our operations entail risks relating to claims or litigation relating to product liability, warranty, product recalls, property damage, misdiagnosis, personal injury and death. We may incur significant liability in the event of any such litigation, regardless of the merit of the action. We currently maintain insurance that we believe is adequate with respect to the nature of the risks insured against, including product liability insurance, professional liability insurance, automobile insurance, property insurance, workers compensation insurance and general liability insurance. In many cases such insurance is expensive and difficult to obtain, and no assurance can be given that we will be able to maintain our current insurance or that we will be able to obtain or maintain comparable or additional insurance in the future on reasonable terms, if at all. If we are unable to obtain insurance, or if our insurance is inadequate to cover claims, our cash reserves and other assets could be jeopardized. Additionally, costs associated with maintaining our insurance could become prohibitively expensive, and our ability to become profitable could be diminished.

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Our manufacturing operations and executive offices are located at a single facility that may be at risk from fire, earthquakes or other natural or man-made disasters or crises.

Our manufacturing operations and executive offices are located at a single facility in Poway, California, near known fire areas and earthquake fault zones. We have taken precautions to safeguard our facilities, including insurance and health and safety protocols. However, any future natural disaster, such as a fire or an earthquake, could cause substantial delays in our operations, damage to or destroy our manufacturing equipment or inventory, and cause us to incur additional expenses. The insurance we maintain against fires and other natural disasters may not be adequate to cover our losses in any particular case.

Additionally, California has experienced significant electrical power shortages and price volatility in recent years, and if our energy costs substantially increase or blackouts interrupt our power supply frequently or for more than a few days, we may have to reduce or temporarily discontinue our normal operations. Any such reduction or disruption of our operations at our facilities could harm our business.

Risks Related to Government Regulation

We must be licensed to handle and use hazardous materials and may be liable for contamination or other harm caused by hazardous materials that we use.

We use hazardous and radioactive materials in our research and development and manufacturing processes, as well as in the provision of our imaging services. We are subject to federal, state and local laws and regulations governing use, storage, handling and disposal of hazardous and radioactive materials and waste products, or hazardous materials. We are currently licensed to handle such hazardous materials in all states in which we operate, but there can be no assurances that we will be able to maintain those licenses in the future. In addition, we must become licensed to handle hazardous materials in all states into which we plan to expand. Obtaining and maintaining those additional hazardous materials licenses is an expensive and time consuming process. If we are unable to obtain and maintain the requisite licenses, we will not be able to expand into a state and our ability to grow and become profitable will be reduced. Additionally, we cannot completely eliminate the risk of contamination or injury resulting from hazardous materials and we may incur liability as a result of any such contamination or injury. In the event of an accident, we could be held liable for damages or penalized with fines and the liability and associated legal costs could exceed our resources.

We have also incurred and may continue to incur expenses related to compliance with environmental laws. Such future expenses or liability could have a significant negative impact on our business, financial condition and results of operations. Further, we cannot assure you that the cost of complying with these laws and regulations will not materially increase in the future.

We spend considerable time and money complying with federal and state laws, regulations, and other rules, and, if we are unable to comply with such laws, regulations and other rules, we could face substantial penalties.

We are directly, or indirectly through our clients, subject to extensive regulation by both the federal government and the states in which we conduct our business, including the federal Medicare and Medicaid anti-kickback laws; other Medicare laws, regulations, rules, manual provisions, and policies that prescribe the requirements for coverage and payment for services performed by us and our DIS customers; the federal False Claims statutes; the federal Health Insurance Portability and Accountability Act of 1996, or HIPAA; the Stark Law; the federal Food, Drug and Cosmetic Act; federal and state radioactive materials laws; state food and drug and pharmacy laws and regulations; state laws that prohibit the practice of medicine by non-physicians and fee-splitting arrangements between physicians and non-physicians; state scope-of-practice laws that require either specific licenses or certifications for our personnel or their direct supervision by the site physician to perform certain tasks in the absence of such licensures or certifications; federal laws, regulations, rules and policies that permit physicians to bill and receive payment for certain diagnostic tests under the Medicare Physician Fee Schedule only if certain conditions are satisfied, including the requirement that the physician either personally perform, or adequately supervise the performance of, the tests using equipment they own or lease, and that prohibit physicians from marking up the cost of tests they purchase, rather than perform or supervise, for Medicare patients; and state law equivalents to any of the foregoing federal laws.

We maintain a compliance program to help identify and correct any compliance issues and remain in compliance with all applicable laws, to train employees, to audit and monitor the Company s operations, to provide for a compliance hotline, and to achieve other compliance goals. Like most companies with compliance programs, we occasionally discover compliance concerns. In such cases, we take responsive action, including, when necessary, corrective measures. There can be no assurance that the Company s responsive actions will insulate us from liability associated with any detected compliance concerns.

If our past or present operations are found to be in violation of any of the laws, regulations, rules or policies described above or the other laws or regulations to which we or our customers are subject, we may be subject to civil and criminal penalties, damages, fines, exclusion from federal or state health care programs, or the curtailment or restructuring of our operations. Similarly, if our customers are found to be non-compliant with applicable laws, they may be subject to sanctions, which could have a negative impact on us. If we are excluded from federal or state health care programs, our customers who participate in those programs could not do business with us. In addition, if we are required to obtain permits or licensure that we do not possess, we may become subject to substantial additional regulation or incur significant expense. Any penalties, damages, fines, curtailment or restructuring of our operations would adversely affect our ability to operate our business and our financial results. The risk of our being found in violation of these laws is increased because many of them have not been fully interpreted by the regulatory authorities or the courts, and their provisions are open to many interpretations and additional legal or regulatory change. Any action against us for violation of these laws, even if we successfully defend against it, could cause us to incur significant legal expenses, divert our management s attention from the operation of our business and damage our reputation.

Legislative or regulatory reform of the healthcare system may affect our ability to sell our products.

Federal and state lawmakers from time to time enact new legislation establishing significant changes in the healthcare system. Downward changes to Medicare reimbursement rates for items such as the procedures our physician clients perform or the drugs used in conjunction with them may adversely affect reimbursement to customers or potential customers that use or could use our cameras and services, and may therefore affect us. Effective January 2007, the technical component of Medicare reimbursement for nuclear imaging services performed in physicians offices was capped at the lesser amount of either the Hospital Outpatient Prospective Payment System rates or the Medicare Part B Physician Fee Schedule rates. As a result of this and other reimbursement changes, the average Medicare reimbursement rate for the imaging procedures most commonly performed by our physician clients declined by 8.5% from 2006 to 2007. Other reimbursement reductions remain under consideration, and we cannot predict whether and to what extent implementation of these reductions will be delayed or whether and how the specific reimbursement rates applicable to procedures performed by our physician clients will be affected. If reimbursement reductions increase, sales of our gamma cameras would suffer and we may receive pressure from our customers to terminate or otherwise modify the lease arrangements for our DIS services. Under such circumstances, our business, financial condition and results of operations could be materially adversely affected. In addition, nuclear medicine is a designated health service under the federal anti-self-referral laws known as the Stark Law that a physician may not refer to an entity with which the physician or an immediate family member has a financial relationship, unless an exception applies. DIS physician customers may be able to meet the in-office ancillary services exception to the Stark Law if they meet the definition of a Group Practice under Stark, personally supervise the individuals performing the nuclear imaging services and bill for them, and if the services are performed in the same building in which the physicians regularly practice medicine. If DIS customers are unable or unwilling to comply with the Stark Law, utilization rates of our services and products will decline and our business will be harmed. The potential for adoption of healthcare reform proposals on a state-by-state basis could require us to develop state-specific marketing and sales approaches and adversely affect the results of operations.

Regulatory changes could have a negative impact on camera sales to and leases with hospitals desiring to use our cameras and services in their outpatient facilities.

In order for hospitals to receive certain payments for their outpatient facilities as hospital outpatient services, including services that utilize our products, these services must be furnished in a provider-based organization or facility, or be covered services furnished under arrangement with the hospital. Failure to meet these requirements may result in reduced payments to the hospitals for their services. The Medicare program has published and revised rules establishing criteria for classifying a facility as provider-based or a service as furnished under arrangement. These rules require an analysis of the facts and circumstances surrounding the delivery by a hospital of a particular service, and hospitals that use our products or DIS services in their outpatient facilities will need to determine if they meet the applicable provider-based or under arrangement requirements. Hospitals that cannot obtain sufficient payments for these services may not purchase a camera from us or enter into arrangements with us for provision of services.

If we fail to comply with various licensure or certification laws, regulations or standards, we may be subject to civil, criminal and/or administrative penalties, which would adversely affect our operations.

All of the states in which we operate require that the imaging technicians operating our cameras be licensed or certified and such licensing and certification requirements are subject to change. Obtaining licenses may take significant time as we expand into additional states or if requirements change. Any lapse in the licensure or certification of our technicians could increase our costs and adversely affect our operations and financial results.

In addition, our DIS services model involves administering and furnishing radiopharmaceuticals and, until recently, pharmacological stress agents, which are regulated as drugs by state and federal agencies, including the FDA and state pharmacy boards. If a state regulatory authority determines that we have operated our business without required permits or licensure, we could be subject to civil, criminal and/or administrative penalties, including the curtailing or halting of our business. In addition, an inability to obtain required licenses or permits where we currently conduct business, or in states where we plan to expand, would require us to modify the business models we can utilize in the affected jurisdictions. In either case, we could incur substantial expense and could encounter substantial operational burdens.

Our products are subject to reporting requirements and recalls even after receiving FDA clearance or approval, which could harm our reputation, business and financial results.

We are subject to medical device reporting regulations that require us to report to the FDA or similar governmental bodies in other countries if our products cause or contribute to a death or serious injury or malfunction in a way that would be reasonably likely to contribute to death or serious injury. In addition, the FDA and similar governmental bodies in other countries have the authority to require the recall of our products in the event of material deficiencies or defects in design or manufacture that could cause adverse health consequences. A government-mandated or voluntary recall by us could occur as a result of component failures, manufacturing errors or design defects, including defects in labeling. Any recall would divert management attention and financial resources and harm our reputation with customers.

If we fail to obtain, or are significantly delayed in obtaining, FDA or foreign regulatory clearances or approvals for future products or product enhancements, or if we or our third party contractors fail to comply with FDA s Quality System Regulation, or the quality regulations of foreign governments, our ability to market and distribute our products will suffer.

Our products are subject to rigorous regulation by the FDA and numerous other federal, state and foreign governmental authorities. In the U.S., the FDA regulates virtually all aspects of a medical device s testing, manufacture, safety, labeling, storage, recordkeeping, reporting, promotion and distribution. Our failure to comply with those regulations could lead to the imposition of administrative or judicial sanctions, including Warning Letters, injunctions, suspensions or the loss of regulatory clearances or approvals, product recalls, termination of distribution, product seizures, injunctions, criminal sanctions or closure of our manufacturing facilities. The process of obtaining regulatory clearances or approvals to market a medical device can be costly and time consuming, and there can be no assurance that such clearances or approvals will be granted on a timely basis, if at all. Commercial distribution of a new medical device generally requires 510(k) clearance or an approved PMA. The FDA will clear marketing of a medical device through the 510(k) process if it is demonstrated that the new product is substantially equivalent to a legally marketed predicate device. The PMA approval process is more costly, lengthy and uncertain than the 510(k) clearance process, and must be supported by extensive data, including data from preclinical studies and human clinical trials. We cannot assure you that we will receive marketing clearance or PMA approval for any of our new products or product enhancements, or that significant delays in the introduction of any new products or product enhancements may not occur. While we have not been required to obtain PMA approval for any of our products, we may in the future have to undergo the lengthier, burdensome, and expensive PMA approval process. Further, pursuant to FDA regulations, we can only market our products for cleared or approved uses.

Our manufacturing processes and those of our third-party manufacturers are required to comply with the FDA s Quality System Regulation, which covers the design, testing, production processes, controls, quality assurance, labeling, packaging, storage and shipping of our devices. In addition, we must engage in extensive recordkeeping and reporting and must make available our manufacturing facility and records for periodic unscheduled inspections by federal, state and foreign agencies, including the FDA. Our failure or our third-party manufacturers failure to pass a Quality System Regulation inspection or to comply with these and other applicable regulatory requirements could result in disruption of our operations and manufacturing delays, and a failure to take adequate corrective action could result in, among other things, Warning Letter(s), withdrawal of our medical device clearances, seizure or recall of our devices, or other civil or criminal enforcement actions.

Foreign governmental authorities that regulate the manufacture and sale of medical devices have become increasingly stringent and, to the extent we now or in the future market and sell our products in foreign countries, we may be subject to rigorous regulation by those foreign governmental authorities. In such circumstances, we would rely significantly on our foreign independent distributors to comply with the varying regulations, and any failures on their part could result in restrictions on the sale of our products in foreign countries.

Modifications to our products may require new 510(k) clearances or pre-market approvals, or may require us to cease marketing or recall the modified products until clearances are obtained.

Any modification to a 510(k)-cleared device that could significantly affect its safety or effectiveness, or that would constitute a major change in its intended use, requires a new 510(k) clearance or, possibly, approval of a PMA. The FDA requires every manufacturer to make this determination in the first instance, but the FDA may review any manufacturer s decision. The FDA may not agree with our decisions regarding whether new clearances or approvals are necessary. If the FDA requires us to seek 510(k) clearance or PMA approval for modification of a previously cleared product for which we have concluded that no clearances or approvals are necessary, we may be required to cease marketing or to recall the modified product until we obtain clearance or approval, and we may be subject to significant regulatory fines or penalties. Further, our products could be subject to recall if the FDA determines, for any reason, that our products are not safe or effective. Any recall or FDA requirement for which we seek additional approvals or clearances could result in delays, fines, costs associated with modification of a product, loss of revenue and potential operating restrictions imposed by the FDA, any of which would harm our business.

Risks Related to Our Financial Results

Our quarterly and annual financial results are difficult to predict and are likely to fluctuate significantly from period to period because our business prospects are uncertain and our DIS leasing services business is seasonal.

Our revenue and results of operations at any given time will be primarily based on the following factors, many of which we cannot control:

- physician, healthcare provider and patient acceptance of our products and services;
- demand for and pricing of our products and services;
- levels of and restrictions upon third-party payor reimbursement for our products and services;
- accreditation and credentialing requirements imposed by third-party payors on physicians and providers of mobile imaging services;
- our ability to retain our DIS customers;
- success and timing of new product offerings, acquisitions, licenses or other significant events by us or our competitors;
- camera purchases by DIS customers;
- our ability to establish and maintain a productive manufacturing, marketing, sales and distribution force;
- the ability of our suppliers to provide us with an adequate supply of necessary components on a timely basis;
- timing and magnitude of our expenditures;
- our ability to reduce our expenses quickly enough to respond to any declines in revenue;
- regulatory approvals and legislative changes affecting the products we may offer or those of our competitors;

the effect of competing technological and market developments; and

interruption in the manufacturing or distribution of our products and services.

Furthermore, we have experienced seasonality in the leasing services offered by DIS. While our physicians are obligated to pay us for all lease days to which they have committed, our contracts permit some flexibility in scheduling when services are to be performed. This accounts for some of the seasonality of our DIS revenues. We cannot predict with certainty the degree to which seasonal circumstances such as the summer slowdown, winter holiday variations and weather conditions may make our revenue unpredictable or lead to fluctuations in our quarterly operating results in the future.

In addition, due to the way that customers in our target markets acquire our products, a large percentage of our orders of cameras is booked during the last month of each quarterly accounting period. As such, a delivery delay of only a few days may significantly impact our quarter-to-quarter comparisons. Moreover, the sales cycle for our cameras is typically lengthy, which may cause us to experience significant revenue fluctuations.

For these reasons, quarterly and annual sales and operating results may vary significantly in the future and period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indicators of future performance. We cannot assure you that our sales will increase or be sustained in future periods. We have experienced, and may continue to experience, significant, unanticipated quarterly and annual losses. Because of these and other factors, our operating results in one or more future reporting periods may fail to meet the expectations of securities analysts or investors, which could cause our stock price to decline significantly.

We have incurred significant and recurring operating losses since our inception in 1985 and we may incur such losses and increased operating expenses in the near term.

We have incurred significant cumulative net losses since our inception in November 1985 and may incur such losses and increased operating expenses in the near term as we, among other things, expand our DIS business, increase marketing, sales and distribution of our current products, and conduct research and development to develop next-generation products and to enhance our existing products.

As a result of these activities, we may not be able to become profitable or, if we do, maintain profitability. If our revenue grows more slowly than anticipated, or if our operating expenses exceed our expectations, our ability to achieve our development and expansion goals would be adversely affected.

Risks Related to Our Intellectual Property and Potential Litigation

Our ability to protect our intellectual property and proprietary technology through patents and other means is uncertain.

Our success depends significantly on our ability to protect our proprietary rights to the technologies used in our products. We rely on patent protection, as well as a combination of copyright, trade secret and trademark laws, and nondisclosure, confidentiality and other contractual restrictions to protect our proprietary technology. However, these legal means afford only limited protection and may not adequately protect our rights, be enforceable or permit us to gain or keep any competitive advantage. Our pending U.S. and foreign patent applications, which include claims to material aspects of our products and procedures that are not currently protected by issued patents, may not issue as patents in a form that will be advantageous to us. Any patents we have obtained or do obtain may be challenged by re-examination or otherwise invalidated or eventually found unenforceable. Both the patent application process and the process of managing patent disputes can be time consuming and expensive. Competitors may attempt to challenge or invalidate our patents, or may be able to design alternative techniques or devices that avoid infringement of our patents, or develop products with functionalities that are comparable to ours.

In the event a competitor infringes upon our patent or other intellectual property rights, litigation to enforce our intellectual property rights or to defend our patents against challenge, even if successful, could be expensive and time consuming and could require significant time and attention from our management. We may not have sufficient resources to enforce our intellectual property rights or to defend our patents against challenges from others.

The medical device industry is characterized by patent litigation and we could become subject to litigation that could be costly, result in the diversion of our management s time and efforts, and require us to pay damages.

Any litigation or claims against us, or claims we bring against others, may cause us to incur substantial costs, could place a significant strain on our financial resources, divert the attention of our management from our core business and harm our reputation. If the relevant patents were upheld as valid and enforceable and we were found to be inadvertently infringing, we could be required to pay substantial damages and/or royalties and could be prevented from selling our products unless we could obtain a license or were able to redesign our system to avoid infringement. Any such license may not be available on reasonable terms, if at all. If we fail to obtain any required licenses or make any necessary changes to our products or technologies, we may be unable to commercialize one or more of our products, which could severely harm our business.

We may be subject to damages resulting from claims that we, or our employees, have wrongfully used or disclosed alleged trade secrets of their former employers.

Many of our employees were previously employed at other medical device companies, including our competitors or potential competitors. Although no claims against us are currently pending, we may be subject to claims that we or our employees have inadvertently or otherwise used or disclosed trade secrets or other proprietary information of their former employers. Litigation may be necessary to defend against these claims. Even if we are successful in defending against these claims, litigation could result in substantial costs and be a distraction to management. If we fail in defending such claims, in addition to paying money damages, we may lose valuable intellectual property rights or personnel. A loss of key research personnel or their work product could hinder or preclude our ability to commercialize our products, which could severely harm our business.

Risks Related to the Securities Markets and Ownership of Our Common Stock

Our stock price may be volatile.

The market price for our common stock has been and is likely to continue to be volatile. In addition, the market price of our common stock may fluctuate significantly in response to a number of factors, most of which we cannot control, including:

- volume and timing of orders for our products and services;
- declining sales of nuclear imaging products and other adverse conditions affecting our target markets;
- the results of delays in introduction of new products, product enhancements, services or technologies by us or our competitors;
- period-to-period variations in our or our competitors results of operations;
- conditions or trends in the medical device industry and the imaging service industry;
- disputes or other developments with respect to intellectual property rights, product liability claims or other litigation;
- our ability to develop, obtain regulatory clearance for, and market, new and enhanced products on a timely basis, or changes in governmental regulations or in the status of our regulatory approvals or applications;
- additions or departures of key personnel;
- sales of large blocks of our common stock, including sales by our executive officers and directors;
- changes in the availability of third-party reimbursement in the United States or other countries;
- changes in earnings estimates or recommendations by securities analysts; and
- general market conditions and other factors, including factors unrelated to our operating performance or the operating performance of our competitors.

Future sales of our common stock may cause our stock price to decline.

A small number of our current stockholders hold a substantial number of shares of our common stock that they may sell in the public market. Sales by our current stockholders of a substantial number of shares, or the expectation that such sale may occur, could significantly reduce the market price of our common stock. Moreover, the holders of a substantial number of our shares of common stock, including shares issued upon the exercise of certain of our warrants, have rights, subject to some conditions, to require us to file registration statements to permit the resale of their shares in the public market or to include their shares in registration statements that we may file for ourselves or other stockholders. We have also registered all common stock that we may issue under our employee benefit plans. Accordingly, these shares can be freely sold in the public market upon issuance, subject to restrictions under the securities laws and the lock-up agreements described above. If any of these

stockholders cause a large number of securities to be sold in the public market, the sales could reduce the trading price of our common stock. These sales also could impede our ability to raise future capital.

Our common stock is thinly traded and an active trading market may not be sustained.

Although we are currently listed for trading on the Nasdaq National Market, an active trading market for our common stock may not be sustained. An inactive market may impair your ability to sell your shares at the time you wish to sell them or at a price that you consider reasonable. Furthermore, an inactive market may impair our ability to raise capital by selling shares and may impair our ability to acquire other businesses, products and technologies by using our shares as consideration.

Anti-takeover provisions in our organizational documents, our Stockholders Rights Plan and Delaware law may prevent or delay removal of current management or a change in control.

Our restated certificate of incorporation and restated bylaws contain provisions that may delay or prevent a change in control, discourage bids at a premium over the market price of our common stock and adversely affect the market price of our common stock and the voting and other rights of the holders of our common stock. These provisions include:

- prohibiting our stockholders from calling a special meeting of stockholders unless they hold not less than 20% of the total number of votes to be cast at such a meeting;
- permitting the issuance of additional shares of up to 10,000,000 shares of preferred stock without stockholder approval upon terms and conditions, and with the rights, preferences and privileges as a board of directors may determine;
- prohibiting our stockholders from making certain changes to our restated certificate of incorporation or restated bylaws except with 66 $^{2}/_{3}$% stockholder approval; and
- requiring advance notice for raising matters of business or making nominations at stockholders meetings.

The rights issued pursuant to our Stockholder Rights Plan will become exercisable, subject to certain exceptions, the tenth day after a person or group announces acquisition of 15% or more of our common stock or announces commencement of a tender or exchange offer the consummation of which would result in ownership by the person or group of 15% or more of our common stock.

In addition, as a Delaware corporation, we are subject to Delaware law, including Section 203 of the Delaware General Corporation Law. In general, Section 203 prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years following the date that the stockholder became an interested stockholder unless certain specific requirements are met as set forth in Section 203.

These provisions alone or together, could have the effect of deterring or delaying changes in incumbent management, proxy contests or changes in control.

If our officers, directors and principal stockholders choose to act together, they may be able to control our management and operations, acting in their best interests and not in the best interests of other stockholders.

Our officers, directors and holders of 5% or more of our outstanding common stock beneficially own a significant amount of our outstanding common stock. As a result, these stockholders, acting together, will be able to significantly influence all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combination transactions. The interests of this group of stockholders may not always coincide with our interests or the interests of other stockholders, and they may act in a manner that advances their best interests and not necessarily those of other stockholders. As a result of their actions or inactions our stock price may decline.

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

We effected the initial public offering of our common stock pursuant to a Registration Statement on Form S-1 (File No. 333-113760) that was declared effective by the Securities and Exchange Commission on June 9, 2004.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit Number	**Description**
3.1(1)	Restated Certificate of Incorporation
3.2(2)	Restated Bylaws
4.1(3)	Form of Specimen Stock Certificate
4.2(4)	Amended and Restated Investors Rights Agreement by and among Digirad Corporation and the investors listed on the schedule attached thereto, dated April 23, 2002, as amended
10.1(1)	Digirad Corporation 2004 Stock Incentive Plan as Amended and Restated April 27, 2006
10.2	

	Asset Purchase Agreement by and between Digirad Corporation, Digirad Imaging Solutions, Inc., Digirad Ultrascan Solutions, Inc. and Ultrascan, Inc. dated May 1, 2007
31.1	Certification of Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated pursuant to the Securities Exchange Act of 1934, as amended
31.2	Certification of Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated pursuant to the Securities Exchange Act of 1934, as amended
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference to the Company s current report on Form 8-K filed with the Securities and Exchange Commission on May 3, 2006.

(2) Incorporated by reference to the Company s quarterly report on Form 10-Q filed with the Securities and Exchange Commission on August 11, 2004.

(3) Incorporated by reference to the Registration Statement on Form S-1 (File No. 333-113760) originally filed with the Securities and Exchange Commission on March 19, 2004, as amended thereafter.

(4) Incorporated by reference to the Company s quarterly report on Form 10-Q filed with the Securities and Exchange Commission on November 2, 2004.

SIGNATURES

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

DIGIRAD CORPORATION

Date: May 7, 2007

By: /s/ MARK L. CASNER
Mark L. Casner

President and Chief Executive Officer

(Principal Executive Officer)

Date: May 7, 2007

By: /s/ TODD P. CLYDE
Todd P. Clyde

Chief Financial Officer

(Principal Financial and Accounting Officer)

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Portions of this exhibit (indicated by asterisks) have been omitted pursuant to a request for confidential treatment and have been separately filed with the Commission.