Andover Medical, Inc.
Form 10-Q
August 08, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x	**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	FOR THE QUARTERLY PERIOD ENDED: JUNE 30, 2008
o	**TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	FOR THE TRANSITION PERIOD FROM TO

Commission file number: 333-142387

ANDOVER MEDICAL, INC.

(Exact name of registrant as specified in its charter)

Delaware	**51-0459931**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

510 Turnpike Street, Ste. 204
N. Andover, MA 01845
(Address of principal executive offices)

Registrant s Telephone Number, Including Area Code: **(978) 557-1001**

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the preceeding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No: o

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

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: There were a total of 36,277,095 shares of the registrant s common stock, par value $.001 per share, outstanding as of August 8, 2008 and no other classes of common stock.

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Andover Medical, Inc.

Quarterly Report on Form 10-Q

Period Ended June 30, 2008

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Andover Medical, Inc.

Condensed Consolidated Balance Sheet

	June 30, 2008	December 31, 2007 (audited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 322,248	$ 560,375
Accounts receivable, net of allowance for doubtful accounts of $1,220,487 and $1,230,842, respectively	2,501,177	2,367,813
Inventories	947,343	938,287
Prepaid expenses and other current assets	100,717	123,215
Total current assets	3,871,485	3,989,690
Property and equipment:		
Property and equipment	1,555,588	1,549,779
Less accumulated depreciation	913,032	800,958
Total property and equipment, net	642,556	748,821
Other assets:		
Goodwill	3,756,858	4,032,089
Intangible assets, net of accumulated amortization of $469,388 and $317,633, respectively	1,639,470	1,791,225
Deposits and other assets	140,897	133,019
Total other assets	5,537,225	5,956,333
Total assets	$ 10,051,266	$ 10,694,844

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

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		June 30, 2008		December 31, 2007 (audited)
LIABILITIES AND SHAREHOLDERS EQUITY				
Current liabilities:				
Accounts payable	$	786,156	$	743,696
Accrued expenses		3,516,747		1,021,383
Current portion of long-term debt		57,393		145,393
Bank Loan				1,604,758
Total current liabilities		4,360,296		3,515,230
Long term liabilities:				
Long-term debt, less current portion		42,047		78,263
Deferred items		58,462		49,670
Redeemable Convertible Series D Preferred stock $0.001 par value, 2,000 authorized, issued and outstanding, Net of Discount of $1,742,465		257,535		
Total long-term liabilities		358,044		127,933
Total liabilities	$	4,718,340	$	3,643,163
Shareholders equity:				
Preferred Stock (Series A and B), $.001 par value; 998,000 shares authorized, 7,341 and 7,813 outstanding, respectively		7		8
Common stock, $.001 par value; 300,000,000 shares authorized, 36,277,095 and 34,846,244 outstanding, respectively		36,277		34,846
Additional paid-in capital		22,378,307		20,108,921
Accumulated deficit		(17,081,665)		(13,092,094)
Total shareholders equity		5,332,926		7,051,681
Total liabilities and shareholders equity	$	10,051,266	$	10,694,844

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

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Andover Medical, Inc.

Condensed Consolidated Statement of Operations

(Unaudited)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Net Revenue	$ 2,160,028	$ 1,605,365	$ 4,299,076	$ 1,605,365
Costs of revenue	1,014,305	658,794	2,250,571	658,794
Gross profit	1,145,723	946,571	2,048,505	946,571
General and administrative salaries and wages	591,016	463,108	1,124,770	728,924
Share-based compensation	131,966	190,942	241,982	870,594
General and administrative expenses	1,103,667	884,771	2,076,117	935,224
Operating loss	(680,926)	(592,250)	(1,394,364)	(1,588,171)
Interest expense	(300,243)	(42,499)	(344,356)	(89,947)
Other income (expense)	(2,216,005)		(2,213,725)	
Interest income	1,452	30,401	3,978	63,124
Loss before income tax expense	(3,195,722)	(604,348)	(3,948,467)	(1,614,994)
Provision for income taxes	4,509	9,944	12,270	19,061
Net loss	$ (3,200,231)	$ (614,292)	$ (3,960,737)	$ (1,634,055)
Preferred dividend	(18,258)		(28,834)	
Net loss available to common shareholders	$ (3,218,489)	$ (614,292)	$ (3,989,571)	$ (1,634,055)
Net loss per share:				
Basic and diluted	$ (0.09)	$ (0.02)	$ (0.11)	$ (0.06)
Basic and diluted available to common shareholders	$ (0.09)	$ (0.02)	$ (0.11)	$ (0.06)
Weighted average number of common shares outstanding:				
Basic and diluted	36,157,597	27,432,371	35,797,453	26,002,131

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

Andover Medical, Inc.

Condensed Consolidated Statement of Cash Flows

For the Six Months Ended June 30,

(Unaudited)

	2008	2007
OPERATING ACTIVITIES:		
Net loss	$ (3,960,737)	$ (1,634,055)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	263,831	45,814
Share based compensation	241,982	870,594
Accrued interest and fees related to discounted financing obligations	257,535	47,448
Late registration penalties to be settled in warrants	2,218,228	
Changes in operating assets and liabilities:		
Accounts receivable, net	(133,364)	(15,282)
Inventory	(9,056)	(48,606)
Prepaid expenses and other current assets	14,618	(46,983)
Accounts payable and accruals	328,388	(285,425)
Net cash used in operating activities	(778,575)	(1,066,495)
INVESTING ACTIVITIES:		
Purchase of property and equipment	(5,809)	(117,912)
Acquisitions	275,231	(3,306,261)
Net cash provided from / (used in) investing activities	269,422	(3,424,173)
FINANCING ACTIVITIES:		
Proceeds / (Payments) on notes payable	(101,933)	(976,868)
Proceeds / (Payments) on bank line of credit	(1,604,758)	457,160
Proceeds / (Payments) on capital leases	(22,283)	102,211
Issuance of common stock		12,500
Issuance of preferred stock, net of offering costs	2,000,000	3,833,350
Net cash provided by financing activities	271,026	3,428,853
Net increase/(decrease) in cash and cash equivalents	(238,127)	(1,061,815)
Cash and cash equivalents at beginning of period	560,375	2,377,572
Cash and cash equivalents at end of period	$ 322,248	$ 1,315,757
Non-cash activities:		
Stock issued for debt	$	$ 62,532
Stock issued for acquisitions	$	$ 3,045,000
Note issued for acquisition	$	$ 100,000
Supplemental cash flow information:		
Cash paid for interest	$ 47,298	$ 31,372
Cash paid for taxes	$ 15,057	$ 15,514

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

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ANDOVER MEDICAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

AS OF JUNE 30, 2008

(UNAUDITED)

NOTE 1 BASIS OF PRESENTATION

The unaudited interim condensed consolidated financial statements as of and for the six months ended June 30, 2008 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. These condensed consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary for a fair statement for the periods presented. The year-end consolidated data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America (GAAP).

These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements of Andover Medical, Inc. (the registrant, the Company, or AMI) and notes thereto included in the Annual Report on Form 10-K/A for the year ended December 31, 2007, filed by the Company with the SEC.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(A) Principles of Consolidation

The interim condensed consolidated financial statements as of June 30, 2008, include the amounts of the Company and each of its wholly-owned subsidiaries. All inter-company accounts and balances have been eliminated in consolidation.

(B) Revenue Recognition

Revenues are recognized on an accrual basis at the time services and related products are provided to patients and collections are reasonably assured, and are recorded at amounts estimated to be received under healthcare contracts with third-party payors, including private insurers, prepaid health plans, and Medicare. Insurance benefits are assigned to the Company by patients receiving medical treatment and related products and, accordingly, the Company bills on behalf of its patients/customers. Under these contracts, the Company provides healthcare services, medical equipment and supplies to patients pursuant to a physician s prescription. The insurance carrier reimburses the Company for these services and products at agreed upon rates. The balance remaining for products or service costs becomes the responsibility of the patient. A systematic process is employed to ensure that sales are recorded at net realizable value and that any required adjustments are recorded on a timely basis. The Company has established an allowance to account for contractual sales adjustments that result from differences between the amount remitted for reimbursement and the expected realizable amount for all payor contracts. Due to the nature of the industry and the reimbursement environment in which the Company operates, certain estimates are required to record net revenues and accounts receivable at their net realizable values at the time products and/or services are provided. Inherent in these estimates is the risk that they will have to be revised or updated as additional information becomes available. Specifically, the complexity of many third-party billing arrangements and the uncertainty of reimbursement amounts for certain services from certain payors may result in adjustments to amounts originally recorded. Such adjustments are typically identified and recorded at the point of cash application, claim denial or account review.

We perform analyses to evaluate the net realizable value of accounts receivable. Specifically, we consider historical realization data, accounts receivable aging trends, other operating trends and relevant business conditions. Because of continuing changes in the health care industry and third-party reimbursement, it is possible that our estimates could change, which could have a material impact on our operations and cash flows.

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The Company also derives commission revenue from contracts it maintains with orthopedic product and supply manufacturers. Commission revenues are recognized upon the shipment of products to customers in accordance with the terms of the Company s distribution agreements.

Certain items provided by the Company are reimbursed under rental arrangements that generally provide for fixed periodic (daily or monthly) payments established by fee schedules for as long as the patient is using the equipment and medical necessity continues (subject to capped rental arrangements which limit the rental payment periods in some instances and which may result in a transfer of title to the equipment at the end of the rental payment period). Once initial delivery of rental equipment is made to the patient, either a monthly billing cycle is established based on the initial date of delivery, or the total amount due if the patient uses the product for less than one month. The Company recognizes rental arrangement revenues ratably over the service period and defers revenue for the portion of the monthly bill which is unearned. No separate payment is earned from the initial equipment delivery and setup process. During the rental period the Company is responsible for servicing the equipment and providing routine maintenance, if necessary.

The Company s revenue recognition policy is consistent with the criteria set forth in Staff Accounting Bulletin 104 *Revenue Recognition* (SAB 104) for determining when revenue is realized or realizable and earned. The Company recognizes revenue in accordance with the requirements of SAB 104 that:

- persuasive evidence of an arrangement exists;
- delivery has occurred;
- the seller s price to the buyer is fixed or determinable; and
- collectibility is reasonably assured.

Included in accounts receivable are earned but unbilled receivables. Unbilled accounts receivable represent charges for equipment and supplies delivered to customers for which invoices have not yet been generated by the billing system. Prior to the delivery of equipment and supplies to customers, we perform certain certification and approval procedures to ensure collection is reasonably assured and that unbilled accounts receivable are recorded at net amounts expected to be paid by customers and third-party payors. Billing delays, ranging from several weeks to several months, can occur due to delays in obtaining certain required payor-specific documentation from internal and external sources, interim transactions occurring between cycle billing dates established for each customer within the billing system and business acquisitions awaiting assignment of new provider enrollment identification numbers. In the event that a third-party payor does not accept the claim for payment, the customer is ultimately responsible.

(C) Cash and Cash Equivalents

The Company considers all highly liquid temporary cash investments with an original maturity of three months or less to be cash equivalents. As of June 30, 2008, there were no cash equivalents.

(D) Fair Value of Financial Instruments

The Company measures its financial assets and liabilities in accordance with accounting principles generally accepted in the United States. The carrying amounts of the Company s financial instruments including cash, accounts receivable, accounts payable, accrued liabilities and loans payable approximate fair value due to the relatively short period to maturity for these instruments.

In September 2006, the FASB issued FAS No. 157, Fair Value Measurements, (FAS 157), which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. FAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements and was effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB FSP 157-2 which delayed the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are

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recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. These nonfinancial items include assets and liabilities such as reporting units measured at fair value in a goodwill impairment test and nonfinancial assets acquired and liabilities assumed in a business combination. Effective January 1, 2008, the Company adopted FAS 157 for financial assets and liabilities recognized at fair value on a recurring basis and the partial adoption of FAS 157 for financial assets and liabilities.

(E) Concentration of Credit Risk

The Company has no significant off-balance sheet concentrations of credit risk such as foreign exchange contracts, options contracts or other foreign hedging arrangements. The Company maintains the majority of its cash balances with one financial institution in the form of a demand deposit.

(F) Use of Accounting Estimates

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

(G) Receivables

Accounts receivable are reported net of allowances for contractual sales adjustments and uncollectible accounts. The majority of our accounts receivable are due from private insurance carriers, Medicare, and Medicaid, as well as from customers under co-insurance provisions. Third-party reimbursement is a complicated process that involves submission of claims to multiple payors, each having its own claims requirements. In some cases, the ultimate collection of accounts receivable subsequent to the service dates may not be known for several months. The Company records its allowance for contractual sales adjustments as a percentage of amounts billed to third party payers. The Company records its allowance for doubtful accounts as a percentage of accounts receivable. The percentage used is based upon historical cash collections, bad debt write-offs and the aging of accounts receivable. The Company has established an allowance to account for contractual sales adjustments that result from differences between ordinary and customary amounts billed for products and services to third-party payors and the expected realizable amounts.

The reconciliation of Accounts Receivable is as follows:

Item	**June 30, 2008**	**December 31, 2007**
Accounts Receivable Gross	3,756,664	3,628,316
Allowance for contractual sales adjustments	(1,011,375)	(1,008,301)

Allowance for Doubtful Accounts	(209,112)	(222,541)
Accounts Receivable Net	2,536,177	2,397,474

(H) Inventories

Inventories are stated using the lower of cost or market, using the first-in, first-out method.

(I) Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Depreciation is provided using the straight-line method over the estimated useful lives of the individual assets (three to seven years). Depreciation expense for the quarter ended June 30, 2008 was $55,376, and for year to date through June 30, 2008 was $112,075. The following table summarizes total Property and Equipment:

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		June 30, 2008		December 31, 2007
Machinery & equipment	$	848,063	$	843,735
Computers & telephone equipment		316,786		315,305
Office furniture & equipment		252,279		252,279
Leasehold & building improvements		76,234		76,234
Vehicles		62,226		62,226
	$	1,555,588	$	1,549,779
Less accumulated depreciation		(913,032)		(800,958)
Net Property and Equipment	$	642,556	$	748,821

(J) Income Taxes

The Company accounts for income taxes under the Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (Statement 109). Under Statement 109, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Under Statement 109, the effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

(K) Loss per Share

The Company has adopted FAS 128, Earnings per Share. Loss per common share is computed by dividing loss available to common shareholders by the weighted average number of common shares outstanding during the period. Stock options were not included in the computation of loss per share for the periods presented because their inclusion is anti-dilutive. On a weighted average basis, the total potential dilutive stock options outstanding at June 30, 2008 were 6,664,231.

(L) Business Segments

The Company utilizes the guidance provided by Statement of Financial Accounting Standards No. 131, Disclosures About Segments Of An Enterprise And Related Information (FAS 131). Certain information is disclosed in accordance with FAS 131, based on the way management organizes financial information for making operating decisions and assessing performance. For the period ending June 30, 2008 and currently, the Company operates in one segment, Durable Medical Equipment (DME).

(M) Stock Based Compensation

The Company maintains one plan, the Andover Medical, Inc. 2006 Employee Stock Incentive Plan (the 2006 Plan) under which key persons employed or retained by the Company or its subsidiaries, and any non-employee director, consultant, vendor or other individual having a business relationship with the Company may receive stock options, stock appreciation rights or restricted stock for up to 15 million shares of the Company s common stock. Under the 2006 Plan, the exercise price of each stock option equals or exceeds the market price of the Company s stock on the date of grant. Stock options are granted at various times and vest over a period determined by the compensation plan, ranging from one month to three years and generally have a maximum term of ten years. Stock appreciation rights (SARs) may be granted in conjunction with any stock options granted under the 2006 Plan and may be exercised by surrendering the applicable portion of the related stock option. Upon the exercise of an SAR, the holder shall be entitled to receive an amount in cash, shares of the Company s common stock or both, in value equal to the excess of the market price of one share of common stock over the option price per share specified in the related stock option multiplied by the number of shares in respect of which the SAR shall have been exercised, with the compensation committee (the Committee), if any, appointed by the Board, having the right to determine the form of payment. Restricted stock may be awarded either alone or in addition to other awards granted under the 2006 Plan, the terms and conditions of which are to be determined by the Committee.

The fair value of each option granted under the 2006 Plan is estimated on the date of grant, using the Black-Scholes option pricing model, based on the following weighted average assumptions:

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	June 30, 2008
Expected life (years)	1.0-10.0
Expected stock price volatility	98.0-280.3%
Expected dividend yield	0.0%
Risk-free interest rate	3.91-5.09%

The risk-free interest rate is based upon the U.S. Treasury yield curve at the time of grant for the respective expected life of the option. The expected life (estimated period of time outstanding) of options was estimated. The expected volatility of the Company s options was calculated using historical data. Expected dividend yield was not considered in the option pricing formula since the Company does not pay dividends and has no current plans to do so in the future. If actual periods of time outstanding and rate of forfeitures differs from the expected rates, the Company may be required to make additional adjustments to compensation expense in future periods.

A summary of the status of the Company s fixed stock option plan as of June 30, 2008 and the changes during the period ended is presented below:

	Options		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term		Aggregate Intrinsic Value
Options outstanding at December 31, 2007	4,715,000	$	0.24	8.63	$	125,000
Granted	2,170,000	$	0.21	9.82		0
Exercised						
Forfeited		$				
Options outstanding at June 30, 2008	6,885,000	$	0.23	9.16	$	125,000
Options exercisable at June 30, 2008	4,510,833	$	0.21	9.16	$	125,000

There were no stock options exercised during the six months ended June 30, 2008.

		Options Outstanding					Options Exercisable	
Range of Exercise Prices		Number Outstanding at June 30, 2008	Weighted Average Remaining Contractual Term (years)		Weighted Average Exercise Price	Number Exercisable at June 30, 2008		Weighted Average Exercise Price
$	0.00 - 0.06	2,500,000	8.18	$	0.06	2,500,000	$	0.06
$	0.07 - 0.38	3,545,000	9.21	$	0.20	1,528,750	$	0.26
$	0.39 - 0.67	840,000	8.86	$	0.54	482,083	$	0.58
Total		6,885,000	9.16	$	0.23	4,510,833	$	0.21

The following table summarizes the status of the Company s non-vested options since inception:

Non-vested Options

	Options		Weighted Average Fair Value
Non-vested at December 31, 2007	1,057,917	$	0.47
Granted	2,170,000	$	0.23
Vested	(853,750)	$	0.52
Forfeited		$	
Non-vested at June 30, 2008	2,374,167	$	0.25

The total fair value of options vested was $496,192 for the period ended June 30, 2008. As of June 30, 2008, there was $706,276 of total unrecognized compensation cost related to non-vested stock options granted under the 2006 Plan. That cost is expected to be recognized over a weighted average period of 1.2 years.

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The Company follows the provisions of Financial Accounting Standards Board Statement (FAS) No. 123R, *Share-Based Payment* (FAS 123R), which require companies to measure and recognize compensation expense for all share-based payments at fair value. For the six month period ended June 30, 2008, the Company recognized $241,982 in compensation expense related to stock options. The recognition of total stock-based compensation expense impacted basic and diluted net income per common share by less than $0.01 during the six month period ended June 30, 2008. The Company calculates the fair value of stock options using the Black-Scholes model. The total value of the stock option awards is expensed ratably over the requisite service period of the employees receiving the awards.

(N) Recent Accounting Pronouncements

In May 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS 162). SFAS 162 seeks to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles for nongovernmental entities. SFAS No. 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411. This pronouncement is not expected to have a material impact on the Company.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, (SFAS 161). SFAS 161 amends and expands the disclosure requirements of FAS No. 133, Accounting for Derivative Instruments and Hedging Activities, (FAS 133). It requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, counter-party credit risk and disclosures about credit-risk-related contingent features in derivative agreements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2008. The Company is evaluating the impact, if any, that FAS 161 will have on its consolidated financial statements of income and financial position.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, SFAS No. 160 will change the accounting for and reporting of minority interests. Under the new standard, minority interests, will be referred to as noncontrolling interests and will be reported as equity in the parent company s consolidated financial statements. Transactions between the parent company and the noncontrolling interests will be treated as transactions between shareholders provided that the transactions do not create a change in control. Gains and losses will be recognized in earnings for transactions between the parent company and the noncontrolling interests, unless control is achieved or lost. SFAS No. 160 requires retrospective adoption of the presentation and disclosure requirements for existing minority interests. All other requirements of SFAS No. 160 shall be applied prospectively. SFAS No. 160 is effective for the Company beginning in the first quarter of fiscal year 2009 and earlier adoption is not permitted. SFAS No. 160 may have a material impact on the Company s consolidated financial position, results of operations and cash flows if it enters into material transactions or acquires a noncontrolling interest after the standard s effective date.

In December 2007, the FASB issued FAS No. 141 (R), Business Combinations, (FAS 141R), which requires most identifiable assets, liabilities, non-controlling interests, and goodwill acquired in a business combination to be recorded at full fair value. Under FAS 141R, all business combinations will be accounted for under the acquisition method. Significant changes, among others, from current guidance resulting from FAS 141R includes the requirement that contingent assets and liabilities and contingent consideration shall be recorded at estimated fair value as of the acquisition date, with any subsequent changes in fair value charged or credited to earnings. Further, acquisition-related costs will be expensed rather than treated as part of the acquisition. FAS 141R is effective for periods beginning on or after December 15, 2008. The Company is evaluating the impact, if any, that FAS 141R will have on its consolidated financial statements of income and financial position.

In February 2007, the FASB issued FAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an Amendment to FAS No. 115, (FAS 159), which permits entities to choose to measure many financial instruments and certain other items at fair value. FAS 159 was effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal

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years. The Company has elected not to measure its eligible financial instruments at fair value and therefore the adoption of FAS 159 did not have an impact on its consolidated financial statements.

NOTE 3 BUSINESS ACQUISITIONS

On May 11, 2007, AMI s wholly-owned subsidiary completed the acquisition of all the issued and outstanding capital stock of Rainier Surgical Incorporated (RSI). Headquartered in Auburn, Washington, RSI specializes in the sales, service, distribution, and marketing of orthopedic DME. Established in 1991, RSI is the largest stock and bill provider of orthopedic DME in the state of Washington. Currently, RSI has more than 45 trained and experienced staff members. Through its stock and bill program, RSI successfully minimizes the overhead cost and expense physicians, clinics, hospitals, and surgery centers incur when prescribing and distributing orthopedic DME products to their patients. The audited net revenue for RSI during 2006 was $5.2 million. The aggregate purchase price paid was $3,835,000, subject to post-closing adjustments and an escrow, consisting of $2,675,000 in cash, an aggregate of 1,472,995 shares of AMI s common stock valued at $900,000, and acquisition costs of approximately $260,000. In June 2008, the post-closing adjustments were finalized, reducing the purchase price approximately $269,000 to a net aggregate purchase price of $3,566,871.

On May 4, 2007, AMI s wholly owned subsidiary completed the acquisition of 100% of the outstanding capital stock of Ortho Medical Products, Inc. (OMI) through a merger, with OMI as the surviving entity. OMI is a full-service company specializing in procedure specific orthopedic DME, respiratory equipment, and orthotics and prosthetics. Founded in 1982, it focuses on servicing the needs of patients in the Tri-State New York Region; specifically, the five boroughs of New York City, Nassau, Suffolk, and Westchester Counties, Northern New Jersey, Upper New York State, and the State of Connecticut. With four locations, three in New York and one in Connecticut, OMI has approximately 25 employees who work to make this network available to Case Managers, Preferred Provider Organizations and Health Maintenance Organizations. OMI has contracted with approximately 50 health insurance payers, plus Medicare and Medicaid. The audited financial performance of OMI for the year ended December 31, 2006 reflected net sales of approximately $3.2 million. The aggregate purchase price paid, subject to post-closing adjustments and an escrow, was $2,579,000, consisting of $134,000 in cash, a promissory note to the sellers in the amount of $100,000 which was paid in May 2008, an aggregate of 3,300,000 shares of AMI common stock valued at $2,145,000, and acquisition costs of approximately $200,000. There were no further post-closing adjustments.

The following is an allocation of the purchase price to the estimated fair value of assets acquired and liabilities assumed for the RSI and OMI acquisitions, as of the respective closing dates. The final purchase price allocations for these acquisitions are presented below.

	OMI	RSI (In thousands)	Total
Assets Acquired:			
Accounts receivable	$ 1,270	$ 1,109	$ 2,379
Prepaid expenses and other current assets	26	25	51
Inventory	70	997	1,067
Property and equipment	165	523	688
Goodwill	1,120	2,637	3,757
Intangible assets	1,065	939	2,004
Total assets acquired	$ 3,716	$ 6,230	$ 9,946
Liabilities Assumed:			
Accounts payable and accrued expenses	$ 553	$ 1,014	$ 1,567
Long-term debt	584	1,528	2,112

Capital leases				122		122
Total liabilities assumed	$	1,137	$	2,664	$	3,801
Net assets acquired	$	2,579	$	3,566	$	6,145

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The acquisitions above have been accounted for using the purchase method of accounting. The Company conducts its own valuations to determine the purchase price allocation process. At any point in time, some valuations and allocations may be preliminary, and subject to further adjustment.

NOTE 4 GOODWILL AND INTANGIBLE ASSETS

Goodwill represents the purchase price of acquired businesses in excess of the fair market value of net assets acquired. In accordance with FAS No. 142, Goodwill and Other Intangible Assets (FAS 142), goodwill and intangible assets with indefinite lives are not subject to amortization, but are monitored annually for impairment, or more frequently if there are other indications of impairment. Any impairment would be measured based upon the fair value of the related asset based on the provisions of FAS 142. Because the Company has one reporting segment under FAS 142, the Company utilizes the entity-wide approach for assessing goodwill for impairment and compares their market value to their net book value to determine if an impairment exists. There were no impairment losses related to goodwill in any of the fiscal periods presented. If AMI determines through the impairment review process that goodwill has been impaired, AMI would record the impairment charge in its consolidated statement of income.

The amount of goodwill as of June 30, 2008, includes $2,636,670 from the RSI acquisition and $1,120,188 related to the OMI acquisition. Goodwill arising from both acquisitions reflects purchase price factors such as their unique position in their market and their geographic position in the Company s development of a nationwide DME distribution network. The goodwill reported for these acquisitions reflect AMI s preliminary purchase price allocation and is subject to change.

The Company has identified intangible assets distinguishable from goodwill from its healthcare contracts with private and government health care insurance companies. Under these contracts, an insurance company reimburses the Company for services and/or products provided to patients at agreed upon rates which follow, in most instances, the Medicare pricing guidelines. The remainder of the Company s fee for products and services is the responsibility of the patient. These contracts enable the Company to work with physicians who treat patients that are members of the insurance plans. Without these contracts the Company cannot seek reimbursement from the insurance company. As an out of network provider, the Company would be forced to seek reimbursement for their entire fee from the patient. These contracts are important to enhancing the Company s revenue generating capabilities.

Intangible assets that are separable from goodwill and have determinable useful lives are valued separately and amortized over their expected useful lives. AMI assesses the impairment of amortizable intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors AMI considers important that could trigger an impairment review include the following:

- a significant underperformance relative to expected historical or projected future operating results;
- a significant change in the manner of AMI s use of the acquired asset or the strategy for AMI s overall business;
- a significant negative industry or economic trend; and
- AMI s market capitalization relative to net book value.

If AMI determines that an impairment review is required, AMI would review the expected future undiscounted cash flows to be generated by the assets. If AMI determines that the carrying value of intangible assets may not be recoverable, AMI would measure any impairment based on a projected discounted cash flow method using a discount rate determined by AMI to be commensurate with the risk inherent in AMI s current business model. If impairment is indicated through this review, the carrying amount of the asset would be reduced to its estimated fair value.

The components of acquired identifiable intangible assets as of June 30, 2008 are as follows:

Health insurance contracts, net of accumulated amortization of $97,235	1,402,969
Non-competition agreements, net of accumulated amortization of $372,154	236,501
	1,639,470

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The components of acquired identifiable intangible assets include: non-competition agreements which are amortized on a straight-line basis over the related estimated lives of the agreements (two to ten years), and health care contracts for third party medical billing (eighteen years). These contractual intangibles have been valued under the income method that considers cash flows attributable to the identified assets, the future revenue growth of the Company at 2.5%, consistent with expectations for the DME sector of the health care industry and a discount rate of 6.27% which was based upon a calculation of the Company s cost of equity.

NOTE 5 LONG TERM LIABILITIES

Long term liabilities consist of the following:

Series D Convertible Preferred Stock, net of discount of $1,742,465	$	257,535
Note payable secured by a vehicle, due in monthly installments with final payment due January 2009		854
Deferred item		58,462
Capital leases		98,586
Less current portion of long term debt		(57,393)
	$	358,044

On May 11, 2007, the Company and its wholly-owned subsidiaries entered into a $5.0 million Credit Agreement with TD Banknorth, N.A. (the Credit Agreement). The borrowing capacity available to the Company under the Credit Agreement consisted of notes representing a two-year $4.0 million Senior Secured Revolving Credit Facility and a two-year $1.0 million Senior Secured Convertible Revolving Acquisition Loan Facility which converts into a three-year term loan. The Credit Agreement subjected the Company to certain covenants including, but not limited to, a maximum total leverage ratio, a minimum debt service coverage ratio, and a maximum annual capital expenditure. On March 28, 2008 the Company obtained replacement financing. On April 1, 2008 the Company used proceeds from this replacement financing to pay the approximately $1.6 million outstanding balance due TD Banknorth. For further discussion regarding the replacement financing see Note 6 of the Notes to Condensed Consolidated Financial Statements.

NOTE 6 STOCKHOLDERS EQUITY

Share-Based Compensation

In accordance with FAS 123R, for the quarter ended June 30, 2008, $131,966, and for the six months ended June 30, 2008, $241,982 of share-based compensation expense was recorded as an increase to additional paid in capital for share-based payment awards made to the Company s employees and directors, based on the estimated fair values of stock options vesting during the periods.

Preferred Stock

The Company s Certificate of Incorporation authorizes the issuance of 1 million shares of $.001 par value preferred stock. The Company s board of directors (the Board of Directors) has the power to designate the rights and preferences of the preferred stock and issue the preferred stock in one or more series.

On March 28, 2008, the Company completed the sale of an aggregate of 2,000 Units at a price of $1,000 per Unit to one existing institutional investor, for a total offering price of $2,000,000 (the Offering). Each Unit consists of one share of Series D Convertible Preferred Stock of the Company (Series D Preferred Stock), convertible at the holder s option into 2,857 shares of common stock, $.001 par value at $0.35 per share, or an aggregate of 5,714,000 shares of common stock (the Underlying Common Stock). The Series D Preferred Stock entitles the holders to cash dividends of 8% per annum on the face value of $1,000 per share. The

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holders of a majority of the Series D Preferred Stock shall be entitled to nominate and elect a majority of the Company s Board of Directors until 50% of the Series D Preferred Stock has been converted into common stock. The Series D Preferred Stock ranks on parity with the outstanding Series A and B Preferred Stock. The Series C Preferred Stock was deauthorized.

The Conversion Price of the Series D Preferred Stock, as well as the exercise price of the Class E Warrants, described below, are subject to full ratchet anti-dilution protection, subject to certain exemptions including the issuance of shares or options to the Company s management not to exceed 10% of the shares of common stock outstanding on a partially diluted basis including shares underlying then outstanding Preferred Stock.

For every share of Underlying Common Stock issuable, the Company issued to the holders of Series D Preferred Stock one Class E Common Stock Purchase Warrant to purchase three shares of common stock, or an aggregate of 17,142,858 shares exercisable for a period of ten years expiring March 28, 2018 at a price of $0.35 per share. The holder of Preferred Stock have the option on March 28, 2010, to either convert its shares into common stock or redeem each share at face value plus all accrued and unpaid dividends. The holders of the Series D Preferred Stock entered into a Security Agreement with the Company and have a lien on all of the Company s properties and assets. In accordance with Statement of Financial Accounting Standards No. 150 *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150) the Series D Preferred Stock is recorded as a Long Term Debt as of March 31, 2008. The maximum amount the company would have to pay upon redemption would be approximately $2.3 million. In accordance with EITF 00-27, a portion of the proceeds were allocated to each class of warrants based on their relative fair value, which totaled $1,354,839 using the Black Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of $645,161 to the Series D preferred shares based upon the difference between the conversion price of those shares and the closing price of the Company s common stock on the date of issuance. Both the fair value of the warrants (Class E) and the beneficial conversion feature were recorded as a discount to the debt obligation. The discount will be amortized as interest expense for a two year period through the redemption date.

The Company used approximately $1.6 million of the proceeds of the Offering to retire bank debt under its credit agreement with TD Banknorth, N.A. and the balance for working capital. The Company terminated all borrowing facilities with TD Banknorth, N.A.

On May 8, 2007 and September 11, 2007, the Company closed an additional portion of its private financing of 44 Units in total of the Company's securities, representing $2,200,000 principal amount of 6% Series B Convertible Preferred Stock at $50,000 face value per Unit. Each Unit is convertible at $.35 per share into 142,850 shares of Common Stock and Class C Warrants exercisable for five years at $.35 per share to purchase 142,850 shares of Common Stock, plus Class D Warrants exercisable for five years at $.35 per share to purchase 142,850 shares of Common Stock. The Preferred Stock is subject to forced conversion if the Common Stock trades above certain target levels. In accordance with EITF 00-27, a portion of the proceeds were allocated to each class of warrants based on their relative fair value, which totaled $2,484,357 using the Black Scholes option pricing model. Further, the Company attributed beneficial conversion features totaling $663,354 to the Series B preferred shares based upon the difference between the conversion price of those shares and the closing price of the Company's common stock on the date of issuance. Both the fair value of the warrants (Series C and D) and the beneficial conversion feature were recorded as a dividend totaling $2,200,000. These dividends were recorded as a reduction of retained earnings and an increase to additional paid-in capital. Under the registration rights agreement, if the Company is unsuccessful in filing a registration statement within 30 days of closing the financing or does not have an effective registration within six (6) months from the December 19, 2007 effective date of the Company s latest registration statement, the Company shall pay a penalty equal to doubling the number of shares of Common Stock issuable upon exercise of Class C and Class D Warrants, a total of an additional 12,571,428 shares. The company used the Black Scholes option pricing model to calculate the fair value of the additional Class C and Class D Warrants. As of June 30, 2008, the Company has accrued $2,218,288 in penalties, under the registration rights agreement, as it has been determined that it did not have an effective registration statement in advance of the deadline.

Common Stock

The Company s Certificate of Incorporation, as amended, authorizes the issuance of 300 million shares of common stock, par value $.001 per share, without cumulative voting rights and without preemptive rights.

The rollforward of the Company s stockholders equity section for the six months ended June 30, 2008 is as follows:

Item	**Preferred Shares**	**$ 0.001 Par Value Preferred Stock**	**Common Shares**	**$ 0.001 Par Value Common Stock**	**Additional Paid-in Capital**	**Retained Earnings**	**Total**
Balance @ 12/31/07	**7,813**	**8**	**34,846,224**	**34,846**	**20,108,921**		