Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

OR

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

For the transition period from ______ to ______

Commission File Number: 000-20997

SRI/Surgical Express, Inc.

(Exact name of registrant as specified in its charter)

Florida	**59-3252632**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**

12425 Race Track Road

Tampa, Florida 33626

(Address of Principal Executive Offices)

(813) 891-9550

(Registrant s Telephone Number)

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

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

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

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

Number of outstanding shares of each class of registrant s common stock as of October 29, 2007:

Common Stock, par value $.001 6,470,978

Table of Contents

INDEX

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. **Financial Statements**

SRI/SURGICAL EXPRESS, INC.

BALANCE SHEETS

(In thousands)

	September 30, 2007 (unaudited)	December 31, 2006
ASSETS		
Cash and cash equivalents	$ 434	$ 283
Accounts receivable, net	12,785	11,390
Inventories, net	7,202	6,715
Prepaid expenses and other assets, net	3,506	2,641
Reusable surgical products, net	20,397	20,954
Property, plant and equipment, net	31,334	32,371
Total assets	$ 75,658	$ 74,354
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable	$ 3,639	$ 2,497
Accounts payable	8,056	6,863
Employee-related accrued expenses	1,489	1,562
Other accrued expenses	3,723	2,764
Mortgage payable	4,346	4,524
Bonds payable	7,225	7,720
Deferred tax liability, net	1,209	1,706
Total liabilities	29,687	27,636
Shareholders equity:		
Preferred stock-authorized 5,000,000 shares of $0.001 par value; no shares issued and outstanding at September 30, 2007 and December 31, 2006.		
Common stock-authorized 30,000,000 shares of $0.001 par value; issued and outstanding 6,470,978 at September 30, 2007 and 6,459,021 at December 31, 2006.	6	6
Additional paid-in capital	31,181	30,353
Retained earnings	14,784	16,359
Total shareholders equity	45,971	46,718
Total liabilities and shareholders equity	$ 75,658	$ 74,354

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

1

Table of Contents

SRI/SURGICAL EXPRESS, INC.

STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Revenues	$ 23,151	$ 23,111	$ 70,245	$ 70,034
Cost of revenues	18,606	17,780	54,731	53,610
Gross profit	4,545	5,331	15,514	16,424
Distribution expenses	1,554	1,464	4,695	4,553
Selling and administrative expenses	3,745	4,079	12,397	12,893
Loss from operations	(754)	(212)	(1,578)	(1,022)
Interest expense	331	340	1,067	914
Other income	(128)		(250)	
Loss before income taxes	(957)	(552)	(2,395)	(1,936)
Income tax benefit	(312)	(313)	(820)	(617)
Net loss	$ (645)	$ (239)	$ (1,575)	$ (1,319)
Loss per share:				
Basic	$ (0.10)	$ (0.04)	$ (0.25)	$ (0.21)
Diluted	$ (0.10)	$ (0.04)	$ (0.25)	$ (0.21)
Weighted average common shares outstanding:				
Basic	6,420	6,339	6,390	6,338
Diluted	6,420	6,339	6,390	6,338

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

Table of Contents

SRI/SURGICAL EXPRESS, INC.

STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Cash flows from operating activities:		
Net loss	$ (1,575)	$ (1,319)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	2,461	2,563
Amortization of reusable surgical products	3,939	3,530
Gain on sale of property, plant and equipment	(44)	
Stock-based compensation expense	510	478
Provision for doubtful accounts	168	
Provision for slow moving inventory	331	
Provision for slow moving reusable surgical products and shrinkage	385	965
Deferred income taxes	(497)	(460)
Change in operating assets and liabilities:		
(Increase) decrease in accounts receivable	(1,563)	996
Increase in inventories	(818)	(110)
Decrease (increase) in prepaid expenses and other assets, net	66	(684)
Increase in accounts payable	1,193	318
Increase in employee-related and other accrued expenses	835	112
Net cash provided by operating activities	5,391	6,389
Cash flows from investing activities:		
Purchases of property, plant and equipment	(1,411)	(1,430)
Purchases of reusable surgical products	(3,767)	(3,710)
Proceeds from sale of property, plant and equipment	87	
Net cash used in investing activities	(5,091)	(5,140)
Cash flows from financing activities:		
Borrowings on notes payable	26,425	
Repayments on notes payable	(26,213)	(729)
Repayments on mortgage payable	(179)	(179)
Repayments of bonds payable	(495)	(495)
Proceeds from exercise of stock options	318	16
Payments on obligation under capital lease	(5)	(6)
Net cash used in financing activities	(149)	(1,393)
Increase (decrease) in cash and cash equivalents	151	(144)
Cash and cash equivalents at beginning of period	283	653
Cash and cash equivalents at end of period	$ 434	$ 509

Supplemental cash flow information:				
Cash paid for interest	$	1,053	$	877
Cash (received) paid for income taxes	$	(385)	$	475
Noncash insurance financing	$	931	$	

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

Table of Contents

SRI/SURGICAL EXPRESS, INC.

NOTES TO FINANCIAL STATEMENTS

(unaudited)

NOTE A BASIS OF PRESENTATION

The accompanying unaudited financial statements of SRI/Surgical Express, Inc. (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the Securities and Exchange Commission s (the SEC) instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they omit or condense footnotes and certain other information normally included in complete financial statements prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, all adjustments of a normal recurring nature that are necessary to present fairly the financial information for the interim periods reported have been made. The accompanying unaudited financial statements should be read in conjunction with the financial statements and notes included in the Company s Form 10-K for the year ended December 31, 2006, filed with the SEC. The results of operations for the three and nine months ended September 30, 2007, are not necessarily indicative of the results that can be expected for the entire year ending December 31, 2007.

The Company presents an unclassified balance sheet as a result of the extended amortization period (predominantly three to six years) of its reusable surgical products. The Company provides reusable surgical products to its customers on a per use basis similar to a rental arrangement.

The Company operates on a 52-53 week fiscal year ending the Sunday nearest December 31. The prior year unaudited financial statements are reflected as of September 30, 2006 for presentation purposes only. The actual end of the prior year period was October 1, 2006. There are 39 weeks included for each of the nine-month periods ended September 30, 2007 and 2006. There are 13 weeks included for each of the three-month periods ended September 30, 2007 and 2006.

NOTE B SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

Management is required to make estimates and assumptions during the preparation of financial statements and accompanying notes in conformity with accounting principles generally accepted in the United States of America. These estimates and assumptions affect the amounts reported in the financial statements and accompanying notes. Actual results could differ materially from those estimates and assumptions.

Accounts Receivable, net

The Company has accounts receivable from hospitals and surgery centers. The Company does not believe that there are substantial credit risks associated with those receivables and does not require any form of collateral from its customers. The allowance for doubtful accounts as of September 30, 2007, and December 31, 2006, was approximately $260,000 and $235,000, respectively. The allowance for doubtful accounts relates to accounts receivable not expected to be collected and is based on management s assessment of specific customer balances, the overall aging of the balances, and the financial stability of the customers. The Company s write-offs for uncollectible accounts (determined based on specific account evaluations) are insignificant to its results of operations. The Company does not customarily charge interest on accounts receivable.

Inventories, net

Inventories consist of raw materials, principally consumables, supplies, and disposable surgical products; work in progress; and finished goods consisting of company-assembled packs of various combinations of raw materials and reusable surgical products. Inventories are valued at the lower of cost or market, with cost being determined on the first-in, first-out method. As of September 30, 2007 and December 31, 2006, inventory consists of the following:

	September 30,	December 31,

	2007	2006
	(in 000 s)	
Raw materials	$ 4,023	$ 3,830
Work in progress	196	114
Finished goods	3,714	3,171
	7,933	7,115
Less: Inventory reserve	(731)	(400)
	$ 7,202	$ 6,715

Table of Contents

Reusable Surgical Products, net

The Company s reusable surgical products, consisting principally of linens (gowns, towels, drapes), basins (stainless steel medicine cups, carafes, trays, basins), and surgical instruments, are stated at cost. Amortization of linens and basins is computed on a basis similar to the units of production method. Estimated useful lives for each product are based on the estimated total number of available uses for each product. The expected total available usage for its linen products using the three principal fabrics (accounting for approximately 82% of the reusable surgical products) is 75, 100, and 125 uses, based on several factors, including the Company s actual historical experience with these products. The Company believes Radio Frequency Identification (RFID) technology enables it to evaluate the useful lives of linen products more efficiently. Basins are amortized over their estimated useful life, which ranges from 25 to 200 uses. Owned surgical instruments are amortized straight-line over a period of four years. Accumulated amortization as of September 30, 2007, and December 31, 2006, was approximately $13.0 million and $11.9 million, respectively.

As of September 30, 2007, and December 31, 2006, the Company had reserves for shrinkage, obsolescence, and scrap related to reusable surgical products of approximately $1.4 million and $1.6 million, respectively.

Revenue Recognition

Revenues are recognized as the agreed upon products and services are delivered, generally daily. Packing slips signed and dated by the customer evidence delivery of product. The Company s contractual relationships with its customers are primarily evidenced by purchase orders or service agreements with terms varying from one to five years, which are generally cancelable by either party.

The Company owns substantially all of the reusable surgical products provided to customers except the surgical instruments. A third party provides most of the surgical instruments that are included in the Company s comprehensive surgical procedure-based delivery and retrieval service. The Company pays a fee to the third party for the use of the surgical instruments. In accordance with Emerging Issues Task Force (EITF) No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, the Company acts as a principal in this arrangement and has reported the revenue gross for the comprehensive surgical procedure-based delivery and retrieval service. The third party agent fee charged to the Company is included in cost of revenues in the statements of operations.

Stock-Based Compensation

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standard No. 123R, *Share-Based Payments,* (SFAS 123R) for its stock-based compensation plans. Under SFAS 123R, all stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period. The cost for all stock-based awards granted subsequent to December 31, 2005, represents the grant-date fair value that was estimated in

Table of Contents

accordance with the provisions of SFAS 123R, utilizing the binomial (Lattice) model. Stock-based compensation expense was $186,000 and $151,000, or $131,000 and $123,000, net of income tax, for the three month periods ended September 30, 2007 and 2006, respectively, which contributed to a $0.02 reduction in basic and diluted earnings per share for each of the three month periods ended September 30, 2007 and 2006. Stock-based compensation expense was $510,000 and $151,000, or $375,000 and $412,000, net of income tax, which contributed to a $0.06 and $0.07 reduction in basic and diluted earnings per share for the nine month periods ended September 30, 2007 and 2006, respectively.

The proceeds from stock option exercises under all stock-based payment arrangements for each of the three month and nine month periods ended September 30, 2007 were $69,000 and $319,000, respectively. The proceeds from stock option exercises under all stock-based payment arrangements for each of the three month and nine month periods ended September 30, 2006 were $0 and $16,000, respectively. There were no capitalized stock-based compensation costs at September 30, 2007 or 2006.

Stock Option Plans

The 1995 Stock Option Plan

The 1995 Stock Option Plan is designed to provide employees with incentive or non-qualified options to purchase up to 700,000 shares of common stock. The options vest ratably over four to five years from the date of the grant. All outstanding options vest upon a change in control of the Company. Options granted under this Plan expire no later than ten years after the date granted or sooner in the event of death, disability, retirement or termination of employment. As of September 30, 2007 and 2006, options to purchase 119,600 and 178,400 shares, respectively, were outstanding. The 1995 Stock Option Plan terminated on December 21, 2005, although that termination does not adversely affect any options outstanding under the Plan.

The 1996 Non-Employee Director Plan

As amended on May 16, 2001, the Non-Employee Director Plan is designed to provide for the grant of non-qualified stock options to purchase up to 200,000 shares of common stock to members of the Board of Directors who are not employees of the Company. At the completion of the Company s initial public offering, each non-employee director was granted options to purchase 4,000 shares of common stock for each full remaining year of the director s term. Thereafter, on the date on which a new non-employee director was first elected or appointed, he or she was automatically granted options to purchase 4,000 shares of common stock for each year of his or her initial term, and was granted options to purchase 4,000 shares of common stock for each year of any subsequent term to which he or she was elected. As of March 2006, the equity component of the director compensation plan was restructured, so that each non-employee director will receive an annual grant of options to purchase 7,500 shares of common stock as of the date of the Annual Shareholder Meeting, beginning with the 2006 Annual Meeting. All options vest ratably over a three year term and have an exercise price equal to the fair market value of the common stock on the date of grant. As of September 30, 2007 and 2006, options to purchase 120,000 and 182,000 shares, respectively, were outstanding, and no options were available to be granted under this Plan. The 1996 Non-Employee Director Plan terminated on July 14, 2006, although that termination does not adversely affect any options outstanding under the Plan.

The 1998 Stock Option Plan

As amended on May 16, 2001, the 1998 Stock Option Plan is designed to provide employees with incentive or non-qualified options to purchase up to 600,000 shares of common stock. The options vest ratably over four to five years from the date of the grant. All outstanding options vest upon a change in control of the Company. Options granted under this Plan expire no later than ten years after the date granted or sooner in the event of death, disability, retirement, or termination of employment. As of September 30, 2007 and 2006, options to purchase 355,500 and 337,500 shares, respectively, were outstanding, and 163,127 and 243,084 options, respectively, were available to be granted under this Plan.

Table of Contents

The 2004 Stock Compensation Plan

The 2004 Stock Compensation Plan is designed to further the interests of the Company and its shareholders by providing incentives in the form of incentive or non-qualified stock options or restricted stock grants to key employees and non-employee directors who contribute materially to the success and profitability of the Company. Under this Plan, restricted stock grants are not considered outstanding options upon grant but are considered issued and outstanding stock. When restricted stock awards are forfeited they are considered as available for grant. The equity awards typically vest ratably over five years from the date of the grant. All outstanding grants vest upon a change in control of the Company. Options granted under this Plan expire no later than ten years after the date granted or sooner in the event of death, disability, retirement, or termination of employment. At the Company s annual meeting of shareholders on May 24, 2007, the shareholders approved an amendment to the 2004 Stock Compensation Plan to authorize an additional 500,000 shares under the Plan. As of September 30, 2007 and 2006, options to purchase 277,000 and 355,200 shares respectively, were outstanding, and 652,200 and 144,000 shares, respectively, were available to be granted as options or restricted stock under this Plan.

The following table summarizes option and restricted stock grant activity from January 1, 2007 through September 30, 200