DIGIRAD CORP
Form 10-Q
October 28, 2008
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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 September 30, 2008

¨ **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, 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.

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

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 October 15, 2008, the registrant had 18,943,937 shares of Common Stock ($0.0001 par value) outstanding.

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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)

	September 30, 2008 (Unaudited)	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 10,313	$ 14,922
Securities available-for-sale	12,938	16,740
Accounts receivable, net	9,970	8,536
Inventories, net	5,750	5,455
Other current assets	1,962	1,786
Total current assets	40,933	47,439
Property and equipment, net	16,628	16,235
Intangible assets, net	2,088	2,631
Goodwill	2,650	2,650
Securities available-for-sale	2,319	
Restricted cash	60	60
Total assets	$ 64,678	$ 69,015
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 2,616	$ 2,650
Accrued compensation	3,372	3,547
Accrued warranty	787	930
Other accrued liabilities	2,766	3,285
Deferred revenue	2,802	2,909
Current portion of long-term debt	102	213
Total current liabilities	12,445	13,534
Long-term debt, net of current portion	62	
Deferred rent	164	234
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.0001 par value: 10,000 shares authorized at September 30, 2008 and December 31, 2007; no shares issued or outstanding at September 30, 2008 and December 31, 2007		
Common stock, $0.0001 par value: 80,000 shares authorized at September 30, 2008 and December 31, 2007; 18,944 and 18,931 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	2	2
Additional paid-in capital	153,139	152,503
Accumulated other comprehensive (loss) income	(333)	123
Accumulated deficit	(100,801)	(97,381)

Total stockholders equity	52,007	55,247
Total liabilities and stockholders equity	$ 64,678	$ 69,015

See accompanying notes.

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Digirad Corporation

Consolidated Statements of Operations

(In thousands, except per share amounts)

(Unaudited)

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Revenues:				
DIS	$ 13,954	$ 13,500	$ 42,032	$ 39,020
Product	6,249	5,274	16,339	16,104
Total revenues	20,203	18,774	58,371	55,124
Cost of revenues:				
DIS	11,235	10,166	33,534	28,771
Product	4,145	3,834	11,046	10,327
Total cost of revenues	15,380	14,000	44,580	39,098
Gross profit	4,823	4,774	13,791	16,026
Operating expenses:				
Research and development	654	868	1,959	2,441
Sales and marketing	2,036	1,624	6,433	5,661
General and administrative	2,941	3,037	8,952	9,126
Amortization of intangible assets	173	217	542	326
Total operating expenses	5,804	5,746	17,886	17,554
Loss from operations	(981)	(972)	(4,095)	(1,528)
Other income (expense):				
Interest income	96	388	634	1,254
Interest expense	(8)	(7)	(27)	(31)
Other	24	3	68	29
Total other income	112	384	675	1,252
Net loss	$ (869)	$ (588)	$ (3,420)	$ (276)
Net loss per common share basic and diluted	$ (0.05)	$ (0.03)	$ (0.18)	$ (0.01)
Weighted average shares outstanding basic and diluted	18,964	18,829	18,943	18,821

See accompanying notes.

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Digirad Corporation

Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine months ended September 30, 2008	2007
Operating activities		
Net loss	$ (3,420)	$ (276)
Adjustments to reconcile net loss income to net cash (used in) provided by operating activities:		
Depreciation	4,243	3,162
Amortization of intangible assets	543	329
Stock-based compensation	630	817
Loss on disposal of assets	56	16
Amortization of premium on securities available-for-sale	255	24
Changes in operating assets and liabilities:		
Accounts receivable	(1,434)	(2,052)
Inventories	(295)	800
Other assets	(176)	115
Accounts payable	(34)	394
Accrued compensation	(175)	(873)
Accrued warranty, deferred rent and other accrued liabilities	(545)	(44)
Deferred revenue	(107)	36
Net cash (used in) provided by operating activities	(459)	2,448
Investing activities		
Payments made in connection with a business acquisition		(8,804)
Purchases of securities available-for-sale	(16,946)	(2,805)
Maturities of securities available-for-sale	17,717	15,726
Purchases of property and equipment	(4,741)	(7,093)
Net cash used in investing activities	(3,970)	(2,976)
Financing activities		
Issuances of common stock	6	21
Repayment of obligations under capital leases	(186)	(199)
Net cash used in financing activities	(180)	(178)
Net decrease in cash and cash equivalents	(4,609)	(706)
Cash and cash equivalents at beginning of period	14,922	10,070
Cash and cash equivalents at end of period	$ 10,313	$ 9,364

See accompanying notes.

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DIGIRAD CORPORATION

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

1. Interim Financial Information

Organization and Business

Digirad Corporation (Digirad), a Delaware corporation, is a leading provider of cardiovascular imaging services and solid-state nuclear medicine imaging products to physician offices, hospitals and other medical services providers. Digirad has two reportable segments, Digirad Imaging Solutions (DIS) and Product. The accompanying consolidated financial statements include the operations of both segments. Intercompany accounts and transactions have been eliminated in consolidation. Substantially all of our revenue arises from sales activity in the United States. 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 and ultrasound imaging procedures under the supervision of our physician customers. DIS physician customers enter into annual lease contracts for imaging services generally delivered on a per-day basis. Our Product segment sells solid-state gamma cameras and provides camera service and maintenance contracts.

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. Inter-company accounts have been eliminated in consolidation. Operating results for the three- and nine-months ended September 30, 2008 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, 2007 in our Annual Report on Form 10-K filed with the Securities and Exchange Commission.

Net Loss Per Share

We calculate net loss per share in accordance with the Statement of Financial Accounting Standards No. 128, *Earnings Per Share* (SFAS 128). 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 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 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 non-vested restricted stock units, options, and warrants. Common stock equivalents are only included in the calculation of diluted earnings per share when their effect is dilutive.

New Accounting Pronouncements

On January 1, 2008, we adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements, and has been partially deferred for non-financial assets and non-financial liabilities, except those that are 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. The partial adoption of SFAS 157 for financial assets and liabilities did not have a material impact on our consolidated financial position, results of operations or cash flows. See Note 5 for the related disclosures regarding fair value measurement of our investments.

In addition, on January 1, 2008, we adopted Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). Under SFAS 159, companies may elect to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. We did not elect to use the fair value option. Therefore, the adoption of SFAS 159 did not impact our consolidated financial position, results of operations or cash flows.

In December 31, 2007, Statement of Financial Accounting Standards No. 141, *Business Combinations* (SFAS 141(R)) was issued and is effective for business combinations with an acquisition date subsequent to December 31, 2008. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. Also, under SFAS 141(R), transaction costs will no longer be considered part of the fair value of an acquisition, and will be expensed as incurred. We will apply the provisions of SFAS 141(R) when applicable.

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In December 2007, Statement of Financial Accounting Standards No. 160, *Reporting of Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51* (SFAS 160) was issued and is effective for financial statements for fiscal years beginning on or after December 1, 2008, and interim periods within those years. SFAS 160 improves the relevance, comparability and transparency of financial information provided to investors by requiring all entities to report noncontrolling (minority) interests in subsidiaries in the same way. Additionally, SFAS 160 eliminates the diversity that currently exists in accounting for transactions between an entity and noncontrolling interests by requiring they be treated as equity transactions. As of September 30, 2008, we did not hold any noncontrolling interests in subsidiaries.

Valuation of Goodwill and Long-Lived Assets

In accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* we review goodwill and long-lived assets for impairment on an annual basis during the fourth quarter, or when events or changes in circumstances indicate that it is more likely than not that the assets might be impaired. During the third quarter, we evaluated whether the decline in our market capitalization resulting from a record low market value of the Company s stock is an indicator of impairment. We concluded that the decline in our stock price is consistent with the declines in the overall market, and that it is possible that this condition will change in the near term. Accordingly, an earlier assessment for impairment was not required. However, it is possible that conditions may remain unchanged or worsen due to economic factors that affect our business, resulting in the need to write down the carrying amount of our goodwill and long-lived assets to fair value at the time of our annual assessment.

2. Financial Statement Details

Inventories consist of the following (in thousands):

	September 30, 2008	December 31, 2007
Raw materials	$ 2,028	$ 2,433
Work-in-progress	3,138	3,197
Finished goods	1,303	655
	6,469	6,285
Less reserves for excess and obsolete inventories	(719)	(830)
	$ 5,750	$ 5,455

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

	September 30, 2008	December 31, 2007
Machinery and equipment	$ 27,692	$ 27,606
Computers and software	3,963	3,224
Leasehold improvements	768	769
Furniture and fixtures	183	183
	32,606	31,782
Less accumulated depreciation and amortization	(15,978)	(15,547)
	$ 16,628	$ 16,235

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

	September 30, 2008	December 31, 2007
Radiopharmaceuticals and consumable medical supplies	$ 706	$ 571
Professional fees	548	479
Outside services and consulting	356	338
Customer deposits	117	356
Facilities and related costs	322	230
Travel expenses	205	233
Sales and property taxes payable	114	446
Other accrued liabilities	398	632
	$ 2,766	$ 3,285

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. Substantially all of the warranty periods are 12 months from the date of sale and thereafter is performed under purchased maintenance contracts. Warranty reserves are established based on historical experience with failure rates and repair costs and the number of systems 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 September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Balance at beginning of period	$ 765	$ 949	$ 930	$ 788
Charges to cost of revenues	257	415	693	1,357
Costs applied to liability	(235)	(434)	(836)	(1,215)
Balance at end of period	$ 787	$ 930	$ 787	$ 930

4. Comprehensive (Loss) Income

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

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Net loss, as reported	$ (869)	$ (588)	$ (3,420)	$ (276)
Unrealized (losses) gains on marketable securities	(173)	84	(456)	149
Comprehensive loss	$ (1,042)	$ (504)	$ (3,876)	$ (127)

5. Investments

We adopted the provisions of SFAS 157, *Fair Value Measurements*, as of January 1, 2008. Under SFAS 157, fair value is based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In

order to increase consistency and comparability in fair value measurements, SFAS 157 establishes a fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value into three broad levels. These levels, in order of highest priority to lowest priority, are described below:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities.

Level 2: Observable prices that are based on inputs not quoted on active markets, but corroborated by market data.

Level 3: Unobservable inputs are used when little or no market data is available.

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We measure available-for-sale securities at fair value on a recurring basis. The fair values of these securities were determined using the following inputs at September 30, 2008 (in thousands):

		Fair Value Measurements at September 30, 2008 Using		
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities:				
Auction rate securities	$ 2,319	$	$	$ 2,319
Corporate debt securities	3,686		3,686	
Government sponsored entities	9,252		9,252	
Total available-for-sale securities:	$ 15,257	$	$ 12,938	$ 2,319

As of September 30, 2008, we held investments in auction rate securities with a par value of $2.5 million which are classified as non-current assets on our balance sheet. Auction rate securities are investment vehicles with long-term or perpetual maturities that pay interest monthly at current market rates reset through a Dutch auction. These monthly auctions have historically provided a liquid market for these securities. Beginning in February 2008, the majority of auctions for these types of securities failed due to the recent liquidity issues experienced in global credit and capital markets. Our auction rate securities followed this trend and experienced multiple failed auctions due to insufficient investor demand. As there is a limited secondary market for these auction rate securities, we have been unable to convert our positions to cash. Our auction rate security investments continue to pay interest according to their stated terms, are fully collateralized by underlying financial instruments (such as corporate and preferred securities as well as student loans) and have maintained AAA credit ratings despite the failure of the auction process.

During August 2008, the broker-dealer engaged by us (broker-dealer), entered into a settlement agreement with the Securities and Exchange Commission, among others, regarding the marketing and selling of auction rate securities. In connection with this settlement, the broker-dealer announced that it will offer to buy the auction rate securities sold by it to its retail clients at par value. We expect to receive an offer to sell the auction rate securities to the broker-dealer at par value. However, until we enter into an enforceable agreement with the broker-dealer, we do not anticipate being in a position to liquidate these investments until there is a successful auction and therefore believe these securities to be temporarily impaired.

Due to the failed auctions beginning in February 2008, the inputs to the valuation model could no longer be corroborated by observable market data; accordingly, these securities were transferred from level 2 to level 3 of the fair value hierarchy under SFAS 157 during the first quarter of 2008. Significant inputs to our valuation model were based on certain assumptions, including the estimated amount of time until the auction rate securities will return to liquidity and how much of the original investment is expected to be recovered. During the nine months ended September 30, 2008, we recorded an unrealized loss of $0.2 million associated with these auction rate securities, which is included as a component of other comprehensive loss within stockholders equity.

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All other securities were valued using significant other observable inputs and were valued by a third party pricing vendor. The valuations were derived via proprietary evaluation models and analytical tools. The inputs were based on objective and publicly available information. These securities are presented as current assets on the balance sheet.

6. Stock-Based Compensation

We have one stock incentive plan under which stock options and restricted stock units 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.

Following is a summary of stock-based compensation costs by classification within the Statements of Operations (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Cost of DIS revenue	$ 12	$ 17	$ 44	$ 61
Cost of product revenue	13	17	38	60
Research and development	11	18	37	62
Sales and marketing	30	2	85	67
General and administrative	151	145	426	574
	$ 217	$ 199	$ 630	$ 824

7. 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 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 13, 2008.

Segment results are as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Gross profit by segment:				
DIS	$ 2,719	$ 3,334	$ 8,498	$ 10,249
Product	2,104	1,440	5,293	5,777
Consolidated gross profit	$ 4,823	$ 4,774	$ 13,791	$ 16,026
(Loss) income from operations by segment:				
DIS	$ (1,243)	$ (89)	$ (3,775)	$ 236
Product	262	(883)	(320)	(1,764)
Consolidated loss from operations	$ (981)	$ (972)	$ (4,095)	$ (1,528)
Depreciation and amortization of tangible and intangible assets by segment:				
DIS	$ 1,385	$ 1,221	$ 4,110	$ 2,771
Product	224	244	676	717
Consolidated depreciation and amortization	$ 1,609	$ 1,465	$ 4,786	$ 3,488

Identifiable assets by segment:				
DIS	$ 29,505	$ 28,498	$ 29,505	$ 28,498
Product	35,173	41,004	35,173	41,004
Consolidated assets	$ 64,678	$ 69,502	$ 64,678	$ 69,502

8. Acquisition

On May 1, 2007, we completed the acquisition of substantially all of the assets and liabilities of Ultrascan, Inc. (Ultrascan), a provider of ultrasound imaging systems and services to physicians offices and hospitals, in exchange for cash consideration of $7.2 million, the assumption of debt obligations totaling $1.5 million (which were repaid at the closing of the acquisition), and direct transaction costs of $0.1 million. Additional consideration, payable in cash and common stock, of up to $3.9 million may be payable to the seller, or its designees, in the event that certain financial milestones are achieved over a four year period commencing on the

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date of the acquisition. The additional consideration will be added to goodwill if and when it is earned. We acquired Ultrascan for purposes of expanding and diversifying our service offering. We accounted for this acquisition under the purchase method of accounting, and accordingly, the purchased assets and liabilities were initially recorded at their estimated fair values at the date of the acquisition. Among other assets, we acquired $2.9 million of amortizable intangible assets and recorded $2.7 million of goodwill. The results of Ultrascan s operations are included in the DIS segment of our consolidated financial statements beginning on the date of the acquisition.

9. Intangible Assets and Goodwill

The components of intangible assets and goodwill consisted of the following (in thousands):

	September 30, 2008		
	Gross Amount	Accumulated Amortization	Net Book Value
Intangibles subject to amortization:			
Customer relationships	$ 2,600	$ 932	$ 1,668
Covenants not to compete	300	85	215
Patents	304	113	191
Trademarks	28	14	14
Total	3,232	1,144	2,088
Intangibles not subject to amortization:			
Goodwill	2,650		2,650
Total intangibles and goodwill:	$ 5,882	$ 1,144	$ 4,738

	December 31, 2007		
	Gross Amount	Accumulated Amortization	Net Book Value
Intangibles subject to amortization:			
Customer relationships	$ 2,600	$ 453	$ 2,147
Covenants not to compete	300	40	260
Patents	304	96	208
Trademarks	28	12	16
Total	3,232	601	2,631
Intangibles not subject to amortization:			
Goodwill	2,650		2,650
Total intangibles and goodwill:	$ 5,882	$ 601	$ 5,281

All patents and trademarks are recorded within the Product segment. All other intangible assets, including goodwill, are recorded within the DIS segment. The aggregate amortization expense related to intangible assets with finite lives for both of the three month periods ended September 30, 2008 and 2007 was $0.2 million and was $0.5 million and $0.3 million for the nine months ended September 30, 2008 and 2007, respectively. Estimated future amortization expense related to intangible assets with finite lives at September 30, 2008 is as follows:

	In Thousands
2008 (remaining 3 months)	$ 172

2009	593
2010	441
2011	347
2012	248
Thereafter	287
Total	$ 2,088

10. 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.

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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 potential future matters.

11. 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* (SFAS 109). The adoption of FIN 48 did not impact our consolidated financial condition, results of operations or cash flows.

As of January 1, 2007, we had unrecognized tax benefits of approximately $1.5 million. There has been no significant change in unrecognized tax benefits through September 30, 2008. Due to the existence of the valuation allowance, future changes in our unrecognized tax benefits will not impact our effective tax rate. We do not expect our unrecognized tax benefits to change significantly over the next 12 months.

We file income tax returns in the U.S. and in various state jurisdictions with varying statutes of limitations. We are no longer subject to income tax examination by tax authorities for years prior to 2003; however, our net operating loss and research credit carry-forwards arising prior to that year are subject to adjustment. Our policy is to recognize interest expense and penalties related to income tax matters as a component of income tax expense. There were no accrued interest and penalties associated with uncertain tax positions as of September 30, 2008.

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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, 2007 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 13, 2008. Operating results are not necessarily indicative of results that may occur in future periods.

This report contains various forward-looking statements regarding our business, financial condition, results of operations and future plans and projects. Forward-looking statements discuss matters that are not historical facts and can be identified by the use of words such as believes, expects, anticipates, intends, estimates, projects, can, could, may, will, would or similar expressions. In this report, for examp forward-looking statements regarding, among other things, our expectations about the rate of revenue growth in specific business segments and the reasons for that growth and our profitability, our expectations regarding an increase in sales, strategic traction and sales and marketing spending, uncertainties relating to our ability to compete, uncertainties relating to our ability to increase our market share, changes in coverage and reimbursement policies of third-party payors and the effect on our ability to sell our products and services, the existence and likelihood of strategic acquisitions, opportunities to sell to larger cardiology practices, and our ability to timely develop new products or services that will be accepted by the market. Although these forward-looking statements reflect the good faith judgment of our management, such statements can only be based upon facts and factors currently known to us. Forward-looking statements are inherently subject to risks and uncertainties, many of which are beyond our control. As a result, 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. For these 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. They give our expectations regarding the future, but are not guarantees. 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 other medical services providers. 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.

We generate revenues within two primary operating segments: our imaging service business (DIS) and our product 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 s 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, but contract with 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. We experience some seasonality in our DIS business related to summer slowdowns (principally relating to vacations), holidays and inclement weather. Historically, 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 from the sale of 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.

Our Market

The target market for our products and services is comprised of approximately 26,000 cardiologists, 130,000 internists and family practitioners, and hospitals in the United States that perform or could perform nuclear cardiac and ultrasound procedures. As of September 30, 2008, we have provided imaging services through DIS to more than 900 physicians and physician groups. We have sold 585 cameras through our product segment. More than half of our DIS nuclear and ultrasound imaging customers are internists or

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other primary care practitioners, and the remainder are cardiologists. We believe our market has been negatively affected by declining reimbursements from Medicare and Medicaid programs, pricing pressures, 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. We expect each of these trends to continue.

Trends and Drivers

The medical device industry, including the market for nuclear and ultrasound imaging systems and services, is highly competitive. Our product business continues to be negatively affected by many factors, including declining healthcare reimbursement rates for cardiac imaging procedures, competition from alternative imaging modalities such as CT Angiography, and declining average selling prices for our product offerings. Despite these reimbursement trends and the slowing economy, we sold more cameras in the third quarter of 2008 in comparison to the third quarter of 2007. In addition, we see increasing opportunities to sell to larger cardiology practices as they seek to increase productivity with more efficient systems by replacing older equipment.

In providing DIS lease services, we continue to face pressure from the competition to reduce our prices. We compete against businesses employing traditional vacuum tube cameras, companies that use older Digirad cameras or low-cost refurbished cameras, and imaging centers that install nuclear gamma cameras and make them available to referring physicians in their geographic vicinity. To counteract pressures from the competition, we diversified the line of imaging services we offer, penetrated new regions, and launched new marketing efforts, all of which have contributed to our revenue growth compared to 2007. In May 2007, we acquired the net assets of Ultrascan, Inc. (Ultrascan ; see Note 8 of the condensed consolidated financial statements included in Part I, Item 1), a mobile ultrasound company with facilities centered around Atlanta, Georgia, and began offering ultrasound imaging services. This acquisition allowed our nuclear imaging business to penetrate the southeast market and convert over one-third of Ultrascan s pre-established customers to nuclear imaging. We now offer ultrasound imaging services outside of the greater Atlanta, Georgia region, and will continue to expand this offering to more locations. We also unveiled our Centers of Influence program during 2007. The Centers of Influence program is a marketing strategy that affiliates us with highly respected academic medical institutions and physicians. The established affiliation provides us with a competitive advantage, which has expanded our customer base and hub locations.

In 2007, our product leadership team re-focused our engineering efforts on the image quality, speed, reliability, cost structure, and overall performance of our multi-headed cameras and software. We expect that these efforts will result in the long-term revenue growth and operating profit for the product segment.

In September 2008, we announced that we had received U.S. Food and Drug Administration (FDA) 510(k) clearance for our new nSPEED® reconstruction software for reduced imaging time and improved image quality with less radiation exposure for patients . With nSPEED, our Cardius® solid-state dedicated cardiac systems can now perform cardiac imaging procedures in as little as three minutes or with one-half the required pharmaceutical dosages.

First Nine Months of 2008 Financial Highlights

Our consolidated revenues were $58.4 million during the nine months ended September 30, 2008 (2008), which represented an increase of $3.2 million, or 5.9%, over the comparable prior year period (2007), primarily due to the increase in revenue in our DIS segment. DIS revenue increased $3.0 million, or 7.7%, as a result of an increase in ultrasound imaging services revenue. In the product business, revenue increased $0.2 million, or 1.5%, as a result of increased maintenance contract revenues. Our consolidated net loss in 2008 was $3.4 million, compared to net loss of $0.3 million during 2007, primarily due to the lower gross profit achieved in our DIS segment due to increased labor, depreciation and other servicing costs.

Our DIS business currently operates in 22 states and the District of Columbia. As of September 30, 2008, DIS operated 96 nuclear gamma cameras and 62 ultrasound imaging systems, compared to 91 nuclear gamma cameras and 44 ultrasound imaging systems as of September 30, 2007. We believe we can improve our overall profitability by improving the utilization of our fleet of gamma cameras and ultrasound machines. We measure efficiency by tracking system utilization, which is measured based on the percentage of days that our nuclear and ultrasound imaging machines are used to deliver services to customers out of the total number of days that they are available to deliver such services. System utilization decreased to 59% for the nine months ended September 30, 2008 compared to 60% for the same period in 2007. We continue to obtain additional hub accreditation to respond to the reimbursement requirements of some third party payors. As of September 30, 2008, we had obtained accreditation from the Intersocietal Commission for the Accreditation of Nuclear Medicine Laboratories (ICANL) for 29 of our 33 DIS hub locations requiring accreditation. We also recently received accreditation for our ultrasound imaging services through the Intersocietal Commission for the Accreditation of Echocardiography Laboratories (ICAEL). As more and more payors require independent accreditation, we are well positioned to meet these reimbursement demands.

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Results of Operations

The following table sets forth our results from operations, expressed as percentages of revenues for the three and nine months ended September 30, 2008 and 2007:

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Revenues:				
DIS	69.1%	71.9%	72.0%	70.8%
Product	30.9	28.1	28.0	29.2
Total revenues	100.0	100.0	100.0	100.0
Total cost of revenues	76.1	74.6	76.4	70.9
Gross profit	23.9	25.4	23.6	29.1
Operating expenses:				
Research and development	3.2	4.6	3.4	4.4
Sales and marketing	10.1	8.7	11.0	10.3
General and administrative	14.6	16.1	15.3	16.6
Amortization of intangible assets	0.9	1.2	0.9	0.6
Total operating expenses	28.8	30.6	30.6	31.9
Loss from operations	(4.9)	(5.2)	(7.0)	(2.8)
Other income	0.6	2.1	1.1	2.3
Net loss	(4.3)%	(3.1)%	(5.9)%	(0.5)%

Comparison of Three Months Ended September 30, 2008 and 2007

Revenues

Consolidated. Consolidated revenue was $20.2 million for 2008, which represents an increase of $1.4 million, or 7.6%, over 2007, due to an increase in the number of cameras sold in 2008 as compared to the prior year quarter and higher DIS revenues associated with an increase in both nuclear and ultrasound imaging services. DIS revenue accounted for 69.1% of total revenues for 2008, compared to 71.9% for 2007. We expect DIS revenue to continue to represent the larger percentage of our consolidated revenue in future periods.

DIS. Our DIS revenue was $14.0 million for 2008, which represents an increase of $0.5 million, or 3.4%, over the prior year quarter. This increase was primarily the result of the expansion of our DIS business.

Product. Our product revenue was $6.2 million for 2008, which represents an increase of $1.0 million, or 18.5%, compared to the prior year quarter. This increase was primarily due to an increase in the number of cameras sold in 2008 to 23 systems as compared to the 17 systems sold in the prior year quarter and an increase in maintenance contract revenues. We saw an increase in sales of refurbished systems in 2008 due to the addition of a new distributor with a primary focus on the sale of refurbished systems. We anticipate that we will continue to experience pricing pressures on our gamma cameras in the future due to the combination of an uncertain economic outlook and declining medical healthcare imaging reimbursement.

Gross Profit

Consolidated. Consolidated gross profit remained unchanged at $4.8 million for 2008 compared to the prior year quarter. Consolidated gross profit as a percentage of revenue decreased to 23.9% for 2008 from 25.4% for 2007. This decrease is the result of increases in cost of goods sold within our DIS segment.

DIS. Cost of DIS revenue consists primarily of labor, radiopharmaceuticals, equipment depreciation, and other costs associated with the provision of services. DIS gross profit was $2.7 million for 2008, which represents a decrease of $0.6 million, or 18.4%, as compared to the prior year quarter, primarily due to increased labor, depreciation and other servicing costs in 2008. DIS gross profit as a percentage of revenue decreased to 19.5% for 2008 from 24.7% for 2007.

Product. Cost of goods sold primarily consists of materials, labor and overhead associated with the manufacturing and warranty of our products. Product gross profit increased to $2.1 million for 2008, representing an increase of $0.7 million, or 46.1%, compared to the prior year quarter. Product gross profit as a percentage of revenue increased to 33.7% for 2008 from 27.3% for 2007 as a result of the increased sales volume in both cameras and maintenance and the associated improved efficiencies in 2008.

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Operating Expenses

Research and Development. Research and development expenses consist primarily of costs associated with the design, development and enhancement of our products. The primary costs are salaries, development material, facility and overhead, consulting fees, and non-recurring engineering costs. Research and development expenses were $0.7 million for 2008, which represents a decrease of $0.2 million, or 24.7%, compared to the prior year quarter. The decrease in research and development expenses was primarily attributable to lower personnel and outside consulting costs. Research and development expenses were 10.5% and 16.5% of product revenue for 2008 and 2007, respectively. In the future, we expect to invest in research and development with a focus on product cost reduction, reliability initiatives and innovation programs as we seek to improve our existing technology.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries, commissions, bonuses, recruiting, travel, marketing and collateral materials and trade shows. Sales and marketing expenses were $2.0 million for 2008, which represents a $0.4 million increase, or 25.4%, compared to the prior year quarter, principally as a result of additional personnel costs. Sales and marketing expenses were 10.1% of total revenue for 2008 compared to 8.7% for 2007. 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 executive personnel, legal related costs, professional fees, outside services, and insurance. General and administrative expenses remained relatively unchanged at $2.9 million for 2008 compared to $3.0 million the prior year quarter. General and administrative expenses were 14.6% of total revenue for 2008 compared to 16.1% for 2007.

Other Income

Other income consists primarily of interest income, net of interest and other expenses. The decrease of $0.3 million in other income is principally due to the $0.2 million loss on the sale of an investment.

Comparison of Nine Months Ended September 30, 2008 and 2007

Revenues

Consolidated. Consolidated revenue was $58.4 million for 2008, which represents an increase of $3.2 million, or 5.9%, over 2007, primarily as a result of higher DIS revenues attributable to the introduction of ultrasound imaging services in May 2007. DIS revenue accounted for 72.0% of total revenues for 2008, compared to 70.8% for 2007.

DIS. Our DIS revenue was $42.0 million for 2008, which represents an increase of $3.0 million, or 7.7%, over the prior year period. This increase was primarily the result of the ultrasound imaging services revenue generated from the assets acquired from Ultrascan in May 2007.

Product. Our product revenue was $16.3 million for 2008, which represents an increase of $0.2 million, or 1.5%, compared to the prior year period. The decrease in revenue from the sale of one fewer gamma camera and the lower average sales prices of the units sold due to selling a larger number of refurbished units sold was offset by an 11.2% increase in maintenance contract revenues.

Gross Profit

Consolidated. Consolidated gross profit was $13.8 million for 2008, representing a decrease of $2.2 million, or 13.9%, compared to the prior year period. This decrease is the result of increases in cost of goods sold within the DIS and Product segments. Consolidated gross profit as a percentage of revenue decreased to 23.6% for 2008 from 29.1% for 2007.

DIS. DIS gross profit was $8.5 million for 2008, which represents a decrease of $1.8 million, or 17.1%, over the prior year period, primarily due to the overall increase in labor, depreciation and other servicing costs. Depreciation costs increased due to our investment in the upgrade of our DIS fleet, which was completed during the second quarter of 2008. DIS gross profit as a percentage of revenue decreased to 20.2% for 2008 from 26.3% for 2007.

Product. Product gross profit decreased to $5.3 million for 2008, representing a decrease of $0.5 million, or 8.4%, compared to the prior year period, primarily due to the increase in sales of lower-margin refurbished systems. Product gross profit as a percentage of revenue decreased to 32.4% for 2008 from 35.9% for 2007.

Operating Expenses

Research and Development. Research and development expenses were $2.0 million for 2008, which represents a decrease of $0.5 million, or 19.7%, compared to the prior year period. The decrease in research and development expenses was primarily attributable to lower personnel and outside consulting costs. Research and development expenses were 12.0% and 15.2% of product revenue for 2008 and 2007, respectively.

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Sales and Marketing. Sales and marketing expenses were $6.4 million for 2008, which represents an increase of $0.8 million, or 13.6%, compared to the prior year period, principally as a result of additional personnel costs. Sales and marketing expenses were 11.0% of total revenue for 2008 compared to 10.3% for 2007.

General and Administrative. General and administrative expenses were $9.0 million for 2008, which represents a decrease of $0.2 million from the prior year period. General and administrative expenses were 15.3% of total revenue for 2008 compared to 16.6% for 2007.

Other Income

The decrease of $0.6 million in other income reflects decreasing market yields, the lower levels of average cash and investments balances in 2008 compared to 2007 as a result of cash used to acquire assets from Ultrascan and the $0.2 million loss on the sale of an investment in the third quarter.

Liquidity and Capital Resources

We require capital principally for 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 September 30, 2008, we had cash, cash equivalents and current securities available-for-sale of $23.3 million. We currently invest our cash reserves in money market funds, U.S. government and 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 capital expenditures and working capital for at least the next 12 months.

In addition, we own auction rate securities with a par value of $2.5 million which are classified as non-current assets on our balance sheet. Auction rate securities are investment vehicles with long-term or perpetual maturities that pay interest monthly at current market rates reset through a Dutch auction. These monthly auctions have historically provided a liquid market for these securities. Beginning in February 2008, the majority of auctions for these types of securities failed due to the recent liquidity issues experienced in global credit and capital markets. Our auction rate securities followed this trend and experienced multiple failed auctions due to insufficient investor demand. As there is a limited secondary market for these auction rate securities, we have been unable to convert our positions to cash. Our auction rate security investments continue to pay interest according to their stated terms, are fully collateralized by underlying financial instruments (such as corporate and preferred securities as well as student loans) and have maintained AAA credit ratings despite the failure of the auction process.

During August 2008, the broker-dealer engaged by us (broker-dealer), entered into a settlement agreement with the Securities and Exchange Commission, among others, regarding the marketing and selling of auction rate securities. In connection with this settlement, the broker-dealer announced that it will offer to buy the auction rate securities sold by it to its retail clients at par value. We expect to receive an offer to sell the auction rate securities to the broker-dealer at par value. However, until we enter into an enforceable agreement with the broker-dealer, we do not anticipate being in a position to liquidate these investments until there is a successful auction and therefore believe these securities to be temporarily impaired.

Due to the failed auctions beginning in February 2008, the inputs to the valuation model could no longer be corroborated by observable market data; accordingly, these securities were transferred from level 2 to level 3 of the fair value hierarchy under SFAS 157 during the first quarter of 2008. Significant inputs to our valuation model were based on certain assumptions, including the estimated amount of time until the auction rate securities will return to liquidity and how much of the original investment is expected to be recovered. During the nine months ended September 30, 2008, we recorded an unrealized loss of $0.2 million associated with these auction rate securities, which is included as a component of other comprehensive loss within stockholders equity.

Net cash used in operations totaled $0.5 million for the nine months ended September 30, 2008, primarily due an increase in accounts receivable. We experienced an increase in our receivables due to an overall increase in days-sales-outstanding (DSO) resulting from seasonality. Net cash used in investing activities amounted to $4.0 million for the nine months ended September 30, 2008, which primarily represents purchases of property and equipment of $4.7 million, offset by net maturities of securities available-for-sale of $0.8 million. Net cash used in financing activities amounted to approximately $0.2 million for the nine months ended September 30, 2008, which represents the repayment of capital lease obligations.

The acquisition of assets and liabilities of Ultrascan may require additional consideration of cash and common stock of up to $3.9 million to be paid to the seller or its designees in the event that certain financial milestones are achieved through May 2011.

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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 September 30, 2008 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, 2007.

New Accounting Pronouncements

On January 1, 2008, we adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements, and has been partially deferred for non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. The partial adoption of SFAS 157 for financial assets and liabilities did not have a material impact on our consolidated financial position, results of operations or cash flows.

In addition, we adopted Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159) on January 1, 2008. Under SFAS 159, companies may elect to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. We did not elect to use the fair value option. Therefore, the adoption of SFAS 159 did not impact our consolidated financial position, results of operations or cash flows.

In December 31, 2007, Statement of Financial Accounting Standards No. 141, *Business Combinations* (SFAS 141(R)) was issued and is effective for business combinations with an acquisition date subsequent to December 31, 2008. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. Also, under SFAS 141(R), transaction costs will no longer be considered part of the fair value of an acquisition, and will be expensed as incurred. We will apply the provisions of SFAS 141(R) when applicable.

In December 2007, Statement of Financial Accounting Standards No. 160, *Reporting of Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51* (SFAS 160) was issued and is effective for financial statements for fiscal years beginning on or after December 1, 2008, and interim periods within those years. SFAS 160 improves the relevance, comparability and transparency of financial information provided to investors by requiring all entities to report noncontrolling (minority) interests in subsidiaries in the same way. Additionally, SFAS 160 eliminates the diversity that currently exists in accounting for transactions between an entity and noncontrolling interests by requiring they be treated as equity transactions. As of September 30, 2008, we did not hold any noncontrolling interests in subsidiaries.

Valuation of Goodwill and Long-Lived Assets

In accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we review goodwill and long-lived assets for impairment on an annual basis during the fourth quarter, or when events or changes in circumstances indicate that it is more likely than not that the assets might be impaired. During the third quarter, we evaluated whether the decline in our market capitalization resulting from a record low market value of the Company s stock is an indicator of impairment. We concluded that the decline in our stock price is consistent with the declines in the overall market, and that it is possible that this condition will change in the near term. Accordingly, an earlier assessment for impairment was not required. However, it is possible that conditions may remain unchanged or worsen due to economic factors that affect our business, resulting in the need to write down the carrying amount of our goodwill and long-lived assets to fair value at the time of our annual assessment.

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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

There have been no changes in our internal control over financial reporting during the third quarter of fiscal 2008 that have materially affected, or are reasonably likely to materially affect, our internal control 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, various regulatory matters, 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

Our revenues may decline due to reductions in Medicare reimbursement rates, competitor activity, or increased third party payor certification requirements.

The success of our DIS business is largely dependent on our customers ability to incorporate our imaging services into a financially viable business. They are faced with the downward trend in Medicare reimbursement rates, as well as the continuing efforts by some third party payors

to reduce health care expenditures by requiring physicians to obtain specific accreditations or certifications, prior authorization requirements and regulators and payors efforts to restrict the use of mobile or leased cameras. Depending on their volume of patients, physicians may find it economical to purchase a camera and either cancel or limit their use of our DIS imaging services. If we are unable to offset the effects of such risks, our financial condition will be harmed.

Our customers may also switch to another service provider. We compete against small local or regional businesses, some of which have the advantage of a lower cost structure, and against imaging centers that install nuclear gamma cameras and make them available to physicians in their geographic vicinity. If these competitors are able to win significant portions of our business, our sales will decline.

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Our Product business competes against businesses that have different competitive strengths than we have.

The market for nuclear imaging cameras has decreased over several years and we expect it to remain flat in the immediate future, thereby making competition a greater challenge. Our competition has negatively impacted our sales prices and volume. Some of our competitors enjoy significant advantages over us, including: greater name recognition; greater financial, technical, service resources; established relationships with healthcare professionals; established distribution networks; and greater resources for product development as well as sales and marketing. Additionally, certain medical device companies are developing alternative mobile cameras that directly compete with our product offerings. If we are unable to expand our current market share, our revenues are likely to decline.

Our quarterly and annual financial results are difficult to predict and are likely to fluctuate from period to period.

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. We cannot predict with certainty the degree to which seasonal circumstances such as the summer slowdown, winter holiday variations and weather conditions will affect the results of our operations. In addition, due to the way that customers in our target markets acquire our products, a large percentage of our camera orders are 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 in the future. Therefore, period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indicators of future performance. 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 additional 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 additional 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 achieve 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.

Our 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 key components of our products. Alternative sources of production and supply 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. We have also outsourced production of significant portions of our end product to a single contract manufacturer. If a disruption in the availability of parts, or in the operations of these suppliers were to occur, our ability to build gamma cameras could be materially affected. Delays in the production of our gamma cameras for an extended period of time could cause the loss of customers and revenue, which could significantly harm our business and results of operations.

Because our DIS services and imaging systems are not widely diversified, obsolescence of our current products and services would seriously harm our business.

We sell products and services primarily in the nuclear imaging market, and began offering DIS services in the ultrasound imaging market in 2007. Our nuclear imaging systems and DIS services may become obsolete or unmarketable if new technologies are introduced to the market or if new industry standards emerge. We may not be able to leverage our assets to diversify our products and services in order to generate revenue beyond the nuclear and ultrasound imaging markets in a timely manner. If we are unable to diversify our product and service offerings, our financial condition may suffer.

Acquisitions could adversely affect our operations and create unanticipated liabilities and other harmful consequences.

We plan to expand our business through certain strategic acquisitions. We cannot assure you that we will successfully complete any given acquisition or that we will successfully integrate any acquired business, product or technology into our company in a cost-effective and non-disruptive manner. Any future transactions may also result in dilutive issuances of equity securities, use of our cash resources, incurrence of debt, and additional recurring expenses such as the amortization of intangible assets. Acquisitions involve

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risks, including: the difficulty of integrating the technology, operations and personnel of our acquired companies into our business; the potential disruption of our ongoing business and distraction of management; additional operating losses and expenses of the acquired businesses; and the impact of known potential liabilities or unknown liabilities. Our failure to successfully address these risks or other problems encountered in connection with our past or future acquisitions could cause us to fail to realize the anticipated benefits and incur unanticipated liabilities, which could harm our business in general.

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. The inability to retain such employees could place a significant strain on our business, which would continue if we experience difficulties in replacing any of them. Hiring qualified management and technical personnel will be difficult due to the limited number of qualified candidates and the intense competition for these types of employees. Furthermore, we have historically suffered high employee turnover. Our future growth and ability to generate profits will depend in part upon our ability to identify, hire, and retain nuclear medicine technologists, certified cardiographic technicians, ultrasound technologists, and sales personnel. If we are unable to reduce employee turnover, our business and financial condition may be adversely affected.

We are highly dependent on the principal members of our executive management team.

The loss of the services of any one or more of the members of our executive management team would diminish the knowledge and experience that we, as an organization, possesses and might significantly harm our sales or delay or prevent the achievement of our research and development objectives. On October 20, 2008, Mark Casner resigned as our President and Chief Executive Officer and as a member of our board of directors. Todd Clyde, our current Chief Financial Officer, has been appointed as our Chief Executive Officer effective as of October 20, 2008, and to our board of directors as of October 23, 2008. Mr. Clyde will also be acting Chief Financial Officer during a transition period. If we are unsuccessful in transitioning our executive management team to compensate for the loss of Mr. Casner and the transition of Mr. Clyde, the achievement of our research, financial, development and commercialization objectives could be significantly delayed or may not occur. In addition, our focus on transitioning to our new management team could divert our management s attention from other business concerns. Furthermore, we may incur additional costs in order to recruit new executive personnel.

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.

Our manufacturing operations and executive offices are located at a single facility in Poway, California, near known fire areas and earthquake fault zones. Any future natural disaster could cause substantial delays in our operations, damage to our manufacturing equipment and inventory, and cause us to incur additional expenses. Although we have taken precautions to insure our facilities and continuing operations, this may not be adequate to cover our losses in any particular case. A disaster could significantly harm our business and results of operations.

A large amount of our common stock is held by a small number of shareholders and is thinly traded.

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. In addition, our common stock is thinly traded and any significant sales of our common stock may cause volatility in our common stock price. 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.

In addition, 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.

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Our investments in auction rate securities are subject to risks which may cause losses and affect the liquidity of these investments.

In accordance with Company policy, we invest our cash reserves in high-grade, highly liquid securities, which include auction rate securities. As of September 30, 2008, we held $2.5 million of principal invested in auction rate securities (ARS), all of which have AAA credit ratings. The auction rate securities held by us are securities with nominal maturities for which the interest rates are reset through a Dutch auction each month. These auctions historically have provided a liquid market for these securities. Our investments in ARS represent interests in collateralized debt obligations supported by pools of corporate and preferred securities and student loans. With the liquidity issues experienced in global credit and capital markets, the ARS held by us at September 30, 2008 have experienced multiple failed auctions as the amount of securities submitted for sale has exceeded the amount of purchase orders.

During August 2008, the broker-dealer engaged by us, entered into a settlement agreement with the Securities and Exchange Commission, among others, regarding the marketing and selling of auction rate securities. In connection with this settlement, the broker-dealer announced that it will offer to buy the auction rate securities sold by it to its retail clients at par value. We expect to receive an offer to sell the auction rate securities to the broker-dealer, however, until such time that an enforceable agreement is entered into with us, we do not anticipate being in a position to liquidate these investments until there is a successful auction. In the event that the current credit markets worsen, we may not be able to recover the full value of our investments in these auction rate securities. We continue to monitor the market for auction rate securities and consider its impact, if any, on the fair value of our investments. If current market conditions deteriorate further, we may be required to record additional losses. We believe that our liquid cash and investments of $23.3 million are adequate to fund our current operations even if we lose access to these securities for an extended period of time. However, should our operations require additional working capital in the future, this lack of liquidity, if it continues, could have a material adverse effect on our operating results and financial condition.

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; and federal rules prohibiting the mark-up of diagnostic tests to Medicare under certain circumstances. If DIS customers are unable or unwilling to comply with these statutes, regulations, rules and policies, utilization rates of our services and products will decline and our business will be harmed.

Nuclear medicine is a designated health service under the federal anti-self-referral laws known as the Stark Law that states 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 certain conditions. From time to time, the Centers for Medicare and Medicaid Services (CMS) modifies the Stark regulations in a manner that may restrict physicians in some business arrangements from utilizing the in-office ancillary services exception to Stark. CMS could at any time propose or implement Stark modifications to limit use of the in-office ancillary services exception. 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. Additionally, CMS continues to make changes to the federal rules prohibiting the mark-up of diagnostic tests to Medicare. Specifically, the final rule provided that effective January 1, 2008, physicians may not mark-up the technical component when a billing physician or supplier purchases a test from an outside supplier, even if the test is done in the office space of the billing physician or supplier. Due, in part, to a lack of clarity in the final rule, CMS has delayed implementing most of the anti-mark up regulations until January 1, 2009, and it intends to issue clarification on the rule before that time. In June 2008, CMS proposed a clarification that the technical component of a diagnostic test is not purchased from an outside supplier if the technical component is supervised by a physician located in the office of the billing physician or other supplier and the test is performed in the medical office space where the practice provides substantially the full range of patient care services that the practice provides generally. If CMS adopts this clarification in its final rule, our leasing arrangements with our physician customers would not be considered a purchased test subject to the anti-markup rule. However, there remains a great deal of uncertainty around the final rules and their implementation.

If DIS customers are unable or unwilling to comply with these final rules, utilization rates of our services and products will decline and our business will be harmed. On the other hand, some interpretations of these rules may create a significant competitive advantage for us over other mobile imaging companies whose business models cannot function under these final rules and their ultimate (and potentially regional) interpretation.

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We maintain a compliance program to 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, 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 corrective measures when necessary. 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. Any penalties, damages, fines, curtailment or restructuring of our operations would adversely affect our ability to operate our business and our financial results. 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.

Economic factors may lead us to write down the carrying amount of our goodwill and long-lived assets.

We review goodwill and long-lived assets for impairment on an annual basis during the fourth quarter, or when events or changes in circumstances indicate that it is more likely than not that the assets might be impaired. During the third quarter, we evaluated whether the decline in our market capitalization resulting from a record low market value of the Company s stock is an indicator of impairment. We concluded that the decline in our stock price is consistent with the declines in the overall market, and that it is possible that this condition will change in the near term. Accordingly, an earlier assessment for impairment was not required. However, it is possible that conditions may remain unchanged or worsen due to economic factors that affect our business, resulting in the need to write down the carrying amount of our goodwill and long-lived assets to fair value at the time of our annual assessment.

Downturns in the U.S. economy may adversely affect operating results.

Weakness in the U.S. economy may adversely affect our operating results. In an economic slowdown, we may also experience the negative effects of increased competitive pricing pressure, customer turnover and disruption in our supply chain. Further, we cannot assure you that an improvement in economic conditions will result in an immediate, if at all positive, improvement in our operating results or cash flows.

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

New federal and state legislations periodically establish significant changes in the healthcare system. For example, downward trends in Medicare reimbursement rates available to our customers have adversely affected our business. If reimbursement rates continue to decrease, or if other legislation with harmful effects is enacted, our product sales could suffer and our DIS customers may modify or terminate their lease arrangements. In addition, 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.

The medical device industry is characterized by litigation that could be costly, result in the diversion of our management s time and efforts, and require us to pay damages which may not be covered by our insurance.

Our operations entail risks relating to claims or litigation relating to product liability, radioactive contamination, patent infringement, trade secret disclosure, warranty claims, product recalls, property damage, misdiagnosis, personal injury and death. 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. We may incur significant liability in the event of any such litigation, regardless of the merit of the action. 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.

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. 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

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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.

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. 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.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

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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
31.1	Certification of Chief Executive Officer and 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 and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) This exhibit was previously filed as an exhibit to the Company s quarterly report on Form 10-Q originally filed with the Commission on August 11, 2004, as amended thereafter, and is incorporated herein by reference.

(2) The exhibit was previously filed as an exhibit to the Company s quarterly report on Form 8-K filed with the Commission on May 9, 2007, and is incorporated herein by reference.

(3) This exhibit was previously filed as an exhibit 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, and is incorporated herein by reference.

(4) This exhibit was previously filed as an exhibit to the Company s quarterly report on Form 10-Q filed with the Commission on November 2, 2004, and is incorporated herein by reference.

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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: October 28, 2008

By: /s/ TODD P. CLYDE
Todd P. Clyde
President, Chief Executive Officer and Chief Financial Officer
(Principal Executive Officer and Principal Financial Officer)

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