

## **IRIS INTERNATIONAL**

**Moderator: César M. García, CEO**  
**August 2, 2006**  
**3:30 p.m. CT**

**Operator:** Good afternoon everyone and welcome, ladies and gentlemen, to the IRIS International Incorporated conference call.

We're discussing – for discussion pertaining to the company's financial results for the second quarter ended June 30th, 2006.

Participating in today's call are Cesar Garcia, president and chief executive officer, and Donald C. Mueller, Chief Financial Officer.

At this time, I'd like to inform you that this conference is being recorded and all participants are in a listen-only mode. A PowerPoint presentation is available for those listening via Webcast. At the request of the company, we will open the conference up to question and answers after the presentation.

This conference call contains forward-looking statements made in reliance upon the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, but are not limited to, the company's views on future financial performance, market growth, capital requirements, new product introductions, financial performance, market growth, capital requirements, new product introductions and acquisitions, and are generally identified by the phrases such as, "thinks," "anticipates," "believes," "estimates," "expects," "intends," "plans," and similar words.

Forward-looking statements are not guarantees of future performance and are inherently subject to uncertainties and other factors which could cause actual results to differ materially from the forward-looking statements. These statements are based upon, among other things, assumptions made by, and information currently available to, management, including management's own knowledge and assessment of the company's industry, R&D initiative, competition, and capital requirements.

Other factors and uncertainties that could affect the company's forward-looking statements include, among other things, the following, identification of feasible new product initiatives, management of R&D efforts and the resulting successful development of new products and product platforms, acceptance by customers of the company's products, integration of acquired businesses, substantial expansion of international sales, reliance on key suppliers, the potential need for changes in long-term strategy and response to future developments, future advances in diagnostic testing methods and procedures, potential changes in government regulations and healthcare policies, both of which could adversely affect the economics and the diagnostic testing procedures automated by the company's products, rapid technology change in the micro electronics and software industries, and competitive factors, include pricing pressures, and the introduction by others of new products with similar or better functionality than our own products.

These and other risks are more fully described in the company's filings with the Securities and Exchange Commission, including the company's most recently filed annual report on form 10-K, and quarterly report on form 10-Q, which should be read in conjunction here with – for further discussion of important factors that could cause actual results to differ materially from those in the forward-looking statements. The company undertakes no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events, or otherwise.

At this time, I'd like to turn the call over to Mr. Garcia, IRIS' president and chief executive officer.

Please go ahead, Mr. Garcia.

**Cesar Garcia:** Thank you, Keith. Welcome everyone to the IRIS International second quarter conference call. Our CFO, Don Mueller, joins me today.

For the last three years, IRIS has delivered excellent results, and our products have become the leader in each of our market segments. We have done that while investing in new technology and building significant infrastructure. The second quarter results that we have just released are disappointing to us, and they're sort of a mixed bag.

On one side, we have significant accomplishments to report; but also a significant disappointment, in terms of domestic sales results, which are down in comparison to the second quarter of 2005, and flat in comparison to the first quarter of 2006. All other aspects of our business – international sales, product development, Sample Processing, the recurring revenue model, which is working as anticipated – all of them are performing per plan.

What I'm trying to convey is that the fundamentals of the business have not changed, but only our domestic execution has been below expectations. The Systems shortfall has been analyzed and new programs are now in place to correct this situation very rapidly. We are confident that our action program will be effective in producing at least 15 percent growth in increase revenue in the second half, over the first half, with a corresponding improvement in profitability.

We have revised our guidance, taking into consideration our performance to date, new marketing on such programs, and correcting the recurring revenue projection that was overestimated and not in line with the business model that I had previously presented to you.

2006 is an investment year and we expect 2007 to be a year of record revenues and earnings, exceeding our initial projections for 2006. I thought that it was very important to give you all a general idea of what happened before our CFO presents our financial results and guidance. After Don's presentation, I will follow up with an in-depth discussion of our business.

Don, please proceed.

**Donald Mueller:** Thank you, Cesar. For those following, if you want to turn to page four, we'll start with the review of segment revenues for the second quarter. Total sales for the second quarter were at \$16.6 million, 10 percent ahead of the same quarter in 2005. In vitro diagnostic segment revenues of 13.8 million grew three percent versus the same prior year quarter, with a 32 percent increase in IVD consumables and service revenue, partially offset by a 19 percent decline in IVD instrument sales. The IVD instruments' revenue decline of 19 percent was greater than the decline in iQ unit shipments of 12 percent, due to a lower shipment mix of domestic full systems in 2006, as compared to 2005. Sample processing segment revenues, of 2.8 million, were up 27 percent from last year.

Now, turning to slide five; total year-to-date sales were 32.8 million, an 11 percent increase over the prior year. In vitro diagnostic segment revenues of 27 million grew eight percent in the first half, with a 30 percent increase in IVD consumables and service revenue, and an 11 percent decline in IVD instrument sales. As with the second quarter, the 11 percent decline in IVD instrument sales was greater than the five percent decline in IVD unit shipments, due to the lower shipment mix of domestic full systems in 2006 versus 2005.

Year-to-date, again, sample processing segment revenues of 5.8 million were up 27 percent versus last year. On slide six, we'll review revenue by geography. We continue to experience significant growth in our international business. On a year-to-date basis, our international revenues of 10.9 million are up 35 percent from last year. Domestically, we've had a modest

increase of 400 thousand, as the increase in IVD consumables and service revenues, and in our domestic sample processing sales, have been offset by the decline in these sales of IVD instruments.

Turning to slide seven, I'd like to review the special and non-recurring charges that we've incurred year-to-date. On a year-to-date basis, these charges have totaled 5.9 million net of tax. And to run through those charges, the most significant item was a \$5.2 million non cash charge for in-process research and development expense to write off research and development assets acquired from Leucadia Technologies that did not qualify for capitalization as core technology intangible assets.

During the quarter, we recorded a \$350 thousand bad debt charge for the default via an S&E of several of our leases. We consider this a special charge due to its relative size and concentration, as compared to historical bad debt experience, which has averaged \$42 thousand over the last three fiscal years.

Also during the quarter, we recorded \$468 thousand of expenses to transition to a new CFO. And finally, in the first half of 2006, we recognized a total of \$345 thousand of incremental stock-based compensation in accordance with the provisions of FAS 123R.

In adopting this pronouncement, we have elected to use the modified perspective method, which does not require restatement of prior periods. Therefore, our 2005 results do not include stock-based compensation for stock options. In order to assist investors in evaluating trends in the company's operating results, without regards to these special and non-recurring items, and the expense related to the adoption of FAS 123R, in the following slides we've excluded these items on an adjusted basis.

On slide eight, the adjusted second quarter gross profit margin of 50.9 improved from last year's 48.8 percent, due primarily to reductions in material costs for IVD instrument production, and the ongoing revenue mix shift to higher margin consumables.

The year-to-date adjusted margin improved as well, from 51.1 percent – or, I'm sorry, to 51.1 percent, versus 49.1 percent for the six months of 2005. Under-utilization of our chemical strip manufacturing facility in Germany, has negatively impacted our gross profit margins by about two points in the second quarter and first half of 2006, with the introduction of the iChem and vChem product line in three – in the third quarter of this year, we now expect to break even at this facility in the second quarter of 2007.

Research and development is a high priority for IRIS, and we have invested \$2.1 million in the second quarter, up \$1.1 million from the first – from – I'm sorry, from the same quarter of last year, and a total of \$3.5 million year-to-date, which was an increase of \$1.5 million from the first half of 2005.

Our R&D spending was driven by development of the urine chemistry instrument and reagent platforms. Our next generation urine microscopy instrument, and investment in urinalysis and cancer detection molecular diagnostic applications. Cesar will provide more detail on progress in this area later in the presentation.

Our adjusted selling, marketing, general and administrative investment increased \$300 thousand from the same quarter of last year, and \$900 thousand year-to-date. The increase for both the quarter and year-to-date was primarily due to increases in personnel costs to strengthen the company's infrastructure. Cesar will discuss additional investments we intend to make in selling and marketing infrastructure in the balance of 2006 later in the presentation.

Our income tax provision reflects an effective tax rate of 37 percent, compared to 40 percent, for both the quarter and year-to-date period of 2006 and 2005, respectively. This change results primarily from recognition of state investment tax credits. If federal – if the federal R&D credit legislation is passed during 2006, we would anticipate a further reduction in this rate later in the year. It's also important to note that as a result of NOL carry-forwards, which currently total \$19.9 million, we expect cash taxes paid for the year will be minimal.

2006 adjusted net income of \$1.4 million declined from \$1.6 million in the second quarter of last year. Adjusted net income was approximately \$3.1 million for the first six months of 2006, up from \$2.8 million in 2005.

I'm turning to slide nine. Adjusted diluted net earnings per share came in at eight cents for the quarter, down \$0.01 from the same quarter of last year. Year-to-date adjusted net earnings per share of \$0.17 were equal to diluted earnings per share for the six-month period of 2005.

Turning now to slide ten, our day sales in receivables have improved to 60 days at June 30, 2006, versus 69 days at the end of 2005. Day sales and inventory, however, have increased to 109 days, from 86 days, due to slower than expected instrument placements. To correct this situation, we have initiated an inventory reduction program, and we expect the days on hand to be back in line with 2005 levels by the end of 2006.

In 2006, we've been focused on expanding and upgrading our facilities. This accounts for \$1.3 million of the \$1.9 million in capital expenditures year-to-date, and we anticipate about \$1.6 million of additional spending this year on facilities expansion. Also, in the year-to-date period, we've used \$3.6 million of cash to fund our acquisition of Leucadia Technologies. We ended the quarter with \$16.5 million in cash and we expect the cash balance to grow to about \$20 million by the end of the year.

On slide 11, discussing our revised guidance; our guidance has been revised, anticipating – and we now anticipate the revenue for the year will be between \$70 and \$71.5 million. Adjusted research and development expense is expected to be approximately 12 percent of revenue. Adjusted net income is expected to be between \$6.5 million and \$6.9 million, with adjusted diluted earnings per share between \$0.35 and \$0.37.

**Cesar Garcia:** Thank you, Don. Now, I'd like to go through an in-depth discussion of our business.

As I said in my opening remarks, we had actually two disappointments. Mostly, the domestic instrument sales, and obviously, we're disappointed with the non-recurring and special items that we had to book. But there are many accomplishments that we achieved in the first half of the year.

Obviously, we have achieved record sales of consumables and service worldwide, we completed the release of the iChem100 and the vChem got 510(K) clearance, and now we're beginning to build a backlog that will carry into the third quarter. We also introduced the market segmentation initiative on the iQ200 to address three different volume-price points.

We have installed now iQ200s in five of the top six hospitals in the U.S. That attests the quality and acceptance of the platform. What we need, is we need more volume, and that's an issue that we will be addressing. We have a major improvement to the iQ200, and the iQ version 5.0 software that's been finished. It is in the validation process and we will be releasing it by the third quarter of 2006.

We also have achieved excellent performance in our Sample Processing Business Unit, and that performance is coming from our investment, in prior periods, in new products; 25 percent of the revenue came from new products. Specifically, the acceptance of the Express 3 has been a resounding success. We have sold over a thousand Express 3 in the first half of the year, and we continue to sell the DNA Hybridization stations through our OEM partners.

Referring to slide number 14, you can –you can see the rapid progress that the company has achieved over the last two years in consumables and service revenue. That is really a confirmation that the assumptions that we used to develop the business plan are sound. And they give us confidence, that if we continue placing units, penetrating the domestic and international markets, our recurring revenue margins and revenues will continue to increase.

Turning to the domestic market, on slide 15 we have put together a situational analysis. Now basically, as I said before, the revenue – the domestic revenue was flat between Q1 and Q2, and it was lower than the revenue in the second quarter of 2005. But it is also important to mention that the second quarter of 2005 was the best quarter in the company history. Why are the domestic instruments sales lower than expected?

In retrospect, I believe that we placed too much emphasis in the international side. And we are coming to the realization that we have insufficient domestic sales coverage. That is something that we will be addressing. We're also experiencing a longer time to close and today, we're going into new accounts. The replacements of our legacy systems is kind of over. We continue to have legacy systems out there, but now we're really penetrating and emphasizing new accounts. When you go into a new account, that hasn't been automated, it takes longer to get through the justification cycle, and the prospect leads that we have reflect that we have significant higher number of new accounts. We have also seen a significant number of multi-unit, multi-side deals. That is really good for continued penetration but you're now looking into much higher capital appropriations and you have much more financial scrutiny by the CEOs and the CFOs of the hospitals.

Also, we're competing for capital. One of the things that is happening in the domestic market is the significant investment in hospital renovations and expansion programs, so capital is tight. I feel that one important point that has to be brought to the table is that we are not losing to the

competition. We are talking to our customers and we have a significant list of prospects. We just have to do a better job in closing.

Going to slide number 16, I want to summarize for you the action plan that we have put together for the second part of the year, and obviously, it concentrates heavily in increasing domestic sales. We're increasing the domestic sales force from eight to 13. The objective of that is not only to address the present situation, but to develop a larger high quality prospect list for 2007 and beyond. We have now a concentrated effort to increase the conversion rates from quotes to sales. So in the second half, the reason why we're projecting at least a 15 percent increase in the instrument sales is that we have, analyzed the prospect list, and we believe that we can close at those rates. But we have also introduced recently, a new iQ200 segmentation strategy. That segmentation strategy will allow us to serve better all markets, and specifically, the need to address the low end of the market.

If you remember, in 2005, we released Sprint to address the high end of the market. We need to stretch down. With a new product line that we're introducing, which we're calling the iQ200 SELECT for the low-end market, the iQ200 ELITE, which is an improved iQ200, and the iQ200 Sprint, we can cover all segments of the market, depending on volume. And we continue to provide value with chemistry and microscopy integration even to low-volume users. One important point is that the SELECT offering. We're going to integrate the iChem100 to the iQ200 SELECT for international shipments, and we're going to integrate the ARKRAY AUCTION JET (AJ4270) to the iQ200 SELECT domestically. So we'll be providing a complete urinalysis solution to the low-volume user.

Going to slide number 17, the second part of our plan is to really make a significant impact in the chemistry market and we have initiated the global launch of the iChem200 and the vChem program. For that, we've recently signed an agreement with Med Tech Associates- they provide 29 domestic sales representatives focused on the physician's office and small labs. It's very

important because it gives us the penetration and at the same time, it allows our capital equipment reps to concentrate in the hospital segments.

We have expanded our distribution. We have signed Mckesson, Cardinal, Fisher, and many other third-party distributors. Internationally, we'll be – we'll be selling the iChem100 and the vChem, through the international distribution channel that we have developed for the iQ200. We have also complemented that international distribution channel by adding the "Quidel channel" – what we call the Quidel channel for the visual read strips. As you may remember from my previous presentation, a significant market of the – a significant segment of the international market is not automated. They use visual-read strips. And honestly, we will promote the pull through of the iChem100 with the iChem – the iQ200 SELECT.

Moving on to the new product initiatives, as we discussed in previous conference calls, IRIS has made the decision to make a significant investment in new product development. In slide number 19 you have – you can see how our platforms are evolving.

On slide number 20, you can see how – the evolution of our evolutionary platforms. When we began this roadmap in 2003, we basically had two technology platforms the iQ200 Microscopy and a line of centrifuges. In 2004, we added the DNA workstation. In 2005, through the acquisition of the Quidel urinalysis business, we added a chemistry platform. And in 2006, we added the Nadia immunoassay technology and the bubble-separation technology.

Moving on to slide 27, I want to give you an update in terms of where we are on the diagnostics R&D pipeline. The semi-automated machine is completely finished, release for the – cleared by the FDA and we initiated shipments already to the international market. We have implemented the first prototype of an automated machine and our target is to have a 510(K) submission by the second quarter of 2007.

And finally, we continue to make progress in our next generation iQ200 and the prototype for the bacteria program was put together, and now we're waiting for the development in the molecular diagnostics group that will be married to our iQ200 system.

To give you an idea of the magnitude of the chemistry market, these are basically the opportunities: 1) it brings the opportunity to provide a complete product line, and, 2) the market by itself, the chemistry market by itself, represents a \$350 million incremental market opportunity. A market that we do not participate on. The reaction at the AACC to the introduction of the iQ200 SELECT, ELITE, and SPRINT, as well as the reaction to the iChem100 and the vChem were excellent.

Moving on to slide number 23, another significant component is our investment in Molecular Diagnostics. First program that we are addressing is NADIA PSA. I am happy to report that we are making significant progress there and on scheduled to submit –a 510(K) application by the fourth quarter of this year. We have already initiated contact with major clinical reference laboratories to begin seeding the technology. The market opportunity is significant,... it's about 200 thousand prostatectomies per year in the U.S. only. That represents about a \$40 million potential market only in the U.S. It's a market niche with no competition and we are planning to have the product introduction during the second half of 2007. Obviously, that depends, in part, on the clearance of the 510(K).

The bacteria program... as I mentioned, we're progressing per schedule. We have assigned the staff, both at Iris Diagnostics and Iris Molecular, and we expect to have the bubble cocktail that will implement the bacteria separation and concentration by June of 2007. Our pipeline for Molecular Diagnostics, on page 24, hasn't changed. We can only tell you that we feel more confident that the PSA application will be on schedule.

In Summary, we have a very comprehensive plan to accelerate the domestic growth in 2006.

2006 is our investment year... investments necessary to achieve record revenues and earnings in 2007 and beyond.

In our guidance, we have incorporated significant revenues and earnings improvements during the second half of 2006, and we're convinced that implementation of our complete urinalysis solution will provide a new vehicle to sell many more consumables, both in microscopy and chemistry.

We have become – we are becoming a full line player, and with the expansion of the iQ200 line, now we can serve the small, the medium and the large segments of the market. Our new product development programs are on target, and our market opportunity just got bigger because it is now approaching \$2 billion.

One thing that Don mentioned is very important. This company continues to perform well, we continue to generate cash, and we will be growing our of cash, to approximately \$20 million by the end of the year, ...and we have \$20 million in NOL.

I would like now to open the floor to questions.

**Operator:** Thank you. Ladies and gentlemen, we will take questions electronically. If you'd like to ask a question, you may do so by hitting star one on your telephone; star one for questions. If using a speakerphone, please make sure the mute function on your phone is turned off so the signal can be read by our equipment. In addition to hitting star one for questions, we do ask that you limit yourself to one question and one follow up; star one for questions. We'll pause a moment to assemble our queue.

We'll go first to Ernie Andberg with Feltl Company. Please go ahead.

Ernie Andberg: Hello, Cesar, Don.

Donald Mueller: Hello, Ernie.

Ernie Andberg: I'll ask a question just on the income statement first, in the second quarter. Where in the operating expenses do the bad debt expense and the CFO transition and the stock-based compensation fall?

Donald Mueller: Well it's in general and administrative expense, primarily. The stock-based compensation is spread throughout the financials with the majority of it being in general administrative expense. So we tried to provide a table that would lay out most of the details of that. But in any – specifically, there's about less than \$100 thousand of the stock-based compensation is in marketing and selling expense.

Ernie Andberg: OK, thank you.

Donald Mueller: Sure.

Ernie Andberg: A tougher question; Cesar.

Cesar Garcia: Yes?

Ernie Andberg: This a pretty big miss, relative to my expectations and I think what the other estimate out there was for, did you consider pre-announcing, particularly, at least when you announced that write-off of the purchased R&D last week?

Cesar Garcia: Ernie, to be honest with you, we considered pre-announcing it, but we felt that it was going to be detrimental to us. We were going to the AACCC last week and going to a major show, announcing that your sales are down would have created a significant problem with our customer base.

Donald Mueller: And also, in terms of the earnings themselves, we did not have the review complete by the auditors and so we did not believe we were in a position to release – to release pre-released earnings.

Operator: OK, we'll take our next question from Steven Crowley with Craig-Hallum Capital Group.  
Please go ahead.

Steven Crowley: Good afternoon, gentlemen.

Cesar Garcia: Hi, Steve.

Steven Crowley: A couple of questions, if you'll permit me, and then I'll get back in the queue to play by the rules. Leucadia expense in the quarter, was that pretty darn consistent with your expectations, and how did that break between categories? Was it a blend of G&A and R&D, or mostly R&D?

Donald Mueller: That was all R&D, consistent with our expectations, about \$400 thousand.

Steven Crowley: One more, a kind of accounting question. The bad debt expense you had in the quarter was obviously surprising.

Donald Mueller: Yes.

Steven Crowley: Can you give us a little bit more of a feel for what happened there and why it's not likely to be recurring in nature?

Donald Mueller: Certainly. Basically what happened is we have – we basically have three leasing companies that we've assigned leases to. This one leasing company – and when I say assigned leases, essentially they buy – they pay us for the instruments and then the consumable – they get paid a stream of income for the principal and interest and for the consumables that they're supposed to remit to us. This one company, which is much smaller than the other companies that we've dealt with, had ceased to make payments to us for a number of months and the prior CFO was negotiating with them.

He thought he was negotiating with them a purchase of their leases, which would have, in fact, not resulted in any loss at all. But as we got close to closing that transaction, it became clear that this leasing company was, in fact, trying to sell us something that they didn't own. They had turned around and sold our assignment to other leasing companies. And so, we were basically – we're in a situation where essentially we were defrauded. In terms of why it won't happen again, basically the other – as I said, the other companies that we deal with are far more substantial, and frankly, I would never let the payment stream get as far behind as it – as it got with this leasing company.

Cesar Garcia: I want to go back to Ernie's questions about the revenue. One thing that is important to keep in mind is that when you have a shortfall in the domestic market, and you're selling a piece of equipment that is \$100 thousand, it doesn't take many units to either make your quarter or miss your quarter. So, if you look in terms of what we have in terms of our internal projections, we were over \$1 million in below our expectations. When you translate that to units, have you actually closed about a dozen units more in the quarter we would have been OK. And that's an – that's an issue that we have with the domestic instrument, they carry such a heavy weight in the equation that our revenue and earnings are very sensitive to the volume of domestic instruments.

Keith, you could take the next question.

Operator: OK, we'll go next to Salomon Kamalodine with B Riley & Co.

Salomon Kamalodine: Hey, good afternoon, guys.

Cesar Garcia: Hello, Salomon.

Salomon Kamalodine: Thanks for taking my question. I guess I'd like to get a little more color on the inventory reduction program that you guys initiated. Do you feel like the longer cell cycles is a – is an issue that's serious enough for you guys to slow production, or how do you guys – how are you thinking about that?

Cesar Garcia: Basically, the inventory is – has two components.

Salomon Kamalodine: Yes.

Cesar Garcia: One of them is the inventory that we purchased from ARKRAY that has a very long-lead time, and we maintain a very healthy inventory on ARKRAY parts because if we experience a spike in demand, they may not be able to cover it. So what we have, are components.

Internally, we produced a significant number of iQ200s because we were confident that we're going to be closing orders according to the forecast. And as you know, in this business most of the instrument sales are realized in the second half of the quarter. So you have a situation that you cannot just wait to the end of the quarter to produce. We have a plan. The reduction in production would result in a reduced absorption that has also been factored into the guidance, and Don can add more to this.

Don Mueller: Yes, I guess what I would add to that is we've got enough flexibility if they're – if we're – if we're wrong on the guidance and there's a spike in demand, we've got enough flexibility in terms of our ability to produce iQs that we could easily ramp up production. But what we're trying to do and what we intend to do, and what we're confident we will be able to is bring that inventory in line with our guidance, but providing enough flexibility that we will not be ever be reporting back to you that we can't make sales because we don't have enough inventory.

Salomon Kamalodine: OK, got it, very helpful. And then, does – did what happened in this quarter have any bearing on your expectations of spending on the R&D related to Leucadia? In other words, are you still looking at this 13 percent R&D expense for the full year?

Cesar Garcia: No, what we did is, if you look at the guidance, we reduced the R&D expenditure to 12 percent on a lower base of revenue. That represents about \$750 thousand in lower R&D for the year. We are doing that by two factors. One is, we are spending our money judiciously. And number two, we have made significant progress on the diagnostics side. And when we looked into the development programs of the diagnostics side, we realized they give us some cushion there. So we're not affecting the deadlines; we're...

Donald Mueller: We're also, if you look in the details of, we're not reducing the spending of IMD. As Cesar was pointing out, it's a reduction in spending, it's a reduction in the diagnostic side, and it's based on progress and how we think, you know, what's appropriate for spending the funds.

Operator: We'll take our next question from Steven Crowley from Craig-Hallum Capital Group.

Steven Crowley: I'm back again, given your new rigid question and answer system here. But a couple of things; I'd like some clarification on your guidance. You talk about 14 to 20 percent gross in the second half over the first half of 2006, and then I believe you also made some comments specific

to instruments. And then, just so I get a chance to ask this, in terms of your efforts to segment the iQ200 product line and open up the lower volume portion of the market, could you tell us a little bit how sizeable that portion of the market is, and how much better you're going to be able to approach that opportunity?

Cesar Garcia: Yes, that's an excellent question, Steve. When we began the design of the iQ200, we identified the market to be about 2,500 domestic sites. Most recently we went back, and what we have – we discovered in – during the most recent market research, is that there have been a significant level of consolidation of that market segment into the higher end, either 200 beds or higher that segment became about 2,000 sites, and we found out that there was probably between 500 and 1,000 additional sites that are in the low end of the market.

So that market becomes very sensitive to volume. So that's what we have to address with the iQ200 SELECT. The difference here is, ...to give you an idea. ...what we're expecting to achieve. We're expecting to sell the iQ200 SELECT connected to the ARKRAY (AJ4270) domestically. The (ASP) estimate is about \$70 thousand per machine, compared to \$100 thousand per machine with the iQ200. It's important to basically keep in mind that when you do introduce \$30 thousand difference in a low-volume hospital, it represents a sizeable reduction in costs per test versus the original iQ200.

So we believe that we will be able to sell more units into that segment. And the conclusion is that you now have about 2,000 sites that are above 200 beds and, 1,000 sites that are below 200 beds, between 200 and 100. So it's a sizeable domestic market.

Steven Crowley: And then in terms of the guidance clarification, for my benefit at least?

Donald Mueller: What is that? Steve, I'm not sure if I follow what you need clarification on.

Steven Crowley: I guess I'm wondering if embedded in your comments, whether you talked about instruments, specifically, or just total revenues?

Donald Mueller: Yes, I don't – I don't think we were planning on giving specific guidance on the instrument numbers.

Cesar Garcia: Well, we're not. Basically what I said is that the instrument revenue, OK?...

Steven Crowley: Yes.

Cesar Garcia: Will grow, , at least at 15 percent.

Donald Mueller: I mean essentially, Steve, you can do the math, I guess, or we can – we could probably give you the math.

Steven Crowley: No, I can certainly do the math; I just wanted to make sure I heard the input correctly.

Donald Mueller: Yes, you did hear it correctly.

Steven Crowley: OK, and the one other question I would have is, you've paid a lot of attention, or you've focused a lot of attention, I think appropriately so, with your move into urine chemistry. You have the initial products coming to market in the third quarter. You kind of sized the total market opportunity for us. But what kind of impact can we have from this product line over the balance of this year and next year? How significant can it be to the company?

Cesar Garcia: Steve, I – if you look in terms of the projection for this year with the iChem100, because what we're leasing now, the iChem100 will have minimal impact. I would say less than \$1 million in revenue in 2006. But we expect that to become very significant for 2007. I do not want to get

into a disclosure at this point in time, but we have very aggressive plans for 2007. But this year, it's only about \$1 million in instruments revenue, and then we will continue to carry what we have in the base and the consumables.

Steven Crowley: OK. I'll circle back if there are other questions.

Donald Mueller: Thank you.

Operator: We'll go next to Harris Hall with Singular Research.

Harris Hall: Good afternoon, guys.

Cesar Garcia: Good afternoon, Harris.

Harris Hall: I was wondering – I know you said that 2006 was kind of a rebuilding year and investment year, and that 2007 should be record revenues. Can you give us a little more granularity on that? Or are we talking 20 percent revenues, 2007 over 2006? Or kind of where do you kind of see sales earnings growth for '07? I know it's a little far out.

Cesar Garcia: Harris, I don't really want to make a projection at this point in time. Last year we issued guidance too early and then we had a situation that we have to live to that guidance. I think that we are going to wait until we go through the third quarter. We're confident that things domestically are going to change, and at the – at the next conference call, in October, we will be issuing the guidance for 2007.

Harris Hall: OK.

Cesar Garcia: I'd want to clarify an answer that I gave to Steve Crowley. The 15 percent that we projected, the 15 percent is for the total revenue of the company, OK? ... is not only instrument. Instrument would be much higher than 15 percent in the second half over the first half. OK? I don't want to disclose the breakdown, but definitely it's much higher, instrument revenue, in the second half. On average, the total corporate revenue,... consolidated revenue will grow at least 15 percent in the second half over the first half.

Operator: We'll go next to Gary Schwab with Ryan Beck. Please go ahead.

Gary Schwab: Hi, yes, hi. Cesar, can you talk a little bit more about the SELECT and what kind of sales mix do you expect between the SELECT and the ELITE on the domestic side of the market, and what this is going to do to the European side of the market where you really never had an instrument before?

Cesar Garcia: Oh, OK. That's very good. The SELECT, like I said, it opens about 1000 sites domestically that we are – either they're very sensitive to a capital equipment cost and also provides a benefit that if the hospital has to decentralize urine chemistry. As in the emergency room: they're doing urine chemistry at the ER, they don't have the volume, or they don't need to automate the urine chemistry in the central lab. So let's say that you have a customer that is doing 40 microscopies) per day, they would qualify for the SELECT. And they will qualify for the connection to the semi-automated machine. So the opportunity here is that you provide complete connectivity and complete integration of chemistry and microscopy, both domestically and internationally.

We're going to sell the SELECT through our international distribution network, and we're going to be selling it combined with the iChem100. Obviously, domestically we do not sell the iChem100 into that market segment, to avoid conflict with ARKRAY in compliance with the distribution

agreements that we have with ARKRAY, It would be a conflict if we sell a competing product, into the automated segments. But internationally we're going to be selling the SELECT, combined.

Gary Schwab: Yes. So when you said Mckesson, Cardinal and Fisher are going to be distributors, they're going to sell the SELECT?

Cesar Garcia: No, they're going to be selling the iChem100 and the vChem .

Gary Schwab: Oh, OK. Well who – you said distributors in the U.S. will sell the SELECT. Who would sell the SELECT? Is Med Tech going to be selling the SELECT?

Cesar Garcia: No, the SELECT will be sold by our direct sales force.

Gary Schwab: Only?

Cesar Garcia: Only, because the as the iQ200 microscopy analyzer, what we're doing, ...we're keeping it – everything that has to do with microscopy will be sold by us.

Gary Schwab: And what is – now you were saying the iQ SELECT, you're talking about the system that's going to sell the \$70 thousand versus the iQ200 system, which was selling for \$100 thousand.

Donald Mueller: That's correct. That's correct.

Gary Schwab: But the actual iQ200, is it the same actual microscopy instrument on both of them?

Cesar Garcia: No, what we did is that ...the – the iQ200 SELECT is a downgraded iQ200. It only works at 40 per hour, versus 70 per hour.

Gary Schwab: OK.

Cesar Garcia: What we did with the line, we segmented the line in three different volume buckets.

Laboratories that need very high volume, they will be buying the Sprint at 101 per hour. The mid range laboratory, they will be buying the iQ200 ELITE, which is a replacement for the iQ200, we're increasing the speed from 60 per hour to 70 per hour. We're introducing – a downgraded version of the iQ200, which is the SELECT that only works at 40 per hour, and can only be operated with a semi-automated chemistry analyzer. So that way, if the hospital wants to perform automated urine chemistry and microscopy, on both sides, they have to buy the ELITE.

If the hospital is willing to do semi-automated testing then – they will buy the iChem100 internationally or the AJ4270 domestically, connected to the SELECT. Did I clarify the...

Gary Schwab: Yes, OK, I do – one last thing, if I can. Did you have hospitals or customers that were sitting on the fence because they didn't want to– pay \$100 thousand for the iQ200 system and they were waiting for you to come out with something that was a little bit cheaper, that they're now ready to go? Is that one of the reasons why possibly your sales were down this quarter, because you got all the low hanging fruit, let's say, and some of these lower-end hospitals were looking for something but they just couldn't spend the extra 30 percent or 40 percent?

Cesar Garcia: That's a factor, but I believe that the thing that affected us the most is that we had a very, very sizeable pipeline, and the pipeline that we have, included many new accounts and then if you're going to a laboratory that has been doing everything manually, and you have to go through the justification with the management, it's much more complicated than if you're doing a replacement. So we have many more new accounts, that's one of the things, and the other thing that we have on our pipeline is a significant number of multi-sites, multi-unit deals. And when you're talking about buying, let's say, three iQ200 systems, then the capital appropriation process is much more complicated because, as I said, it's a \$300 thousand purchase.

So it has to go through a very tight scrutiny by the CFO and CEO of the hospitals.

Gary Schwab: Yes, OK. All right, thanks, Cesar.

Cesar Garcia: Thank you, Gary.

Operator: We'll go next to Dennis Kaffel with Brill Securities.

Dennis Kaffel: Brill Securities. Hi, Cesar.

Cesar Garcia: Hi, Dennis, how are you doing?

Dennis Kaffel: You said you expect a pickup in the second half in instrument sales.

Cesar Garcia: That's correct.

Dennis Kaffel: We're already into one month – one month into the third quarter. Have you seen any pickup up to this point in instrument sales?

Cesar Garcia: Yes, we saw a pickup on the domestic side, and the month of July was a good month on the domestic side.

Dennis Kaffel: Can you quantify that at all?

Cesar Garcia: No.

Dennis Kaffel: OK.

Cesar Garcia: And as you know, the third quarter is typically seasonal in Europe, so it's July is a...

Dennis Kaffel: Right.

Cesar Garcia: ...an OK month. August is dead and September, it's very heavy, so we really have to wait until September to see what is happening, what is going to happen in the international market. But the indication is that we're going to have a decent quarter.

Dennis Kaffel: OK, very good, thank you.

Cesar Garcia: OK.

Operator: Ladies and gentlemen, we have one question in the queue, but we want to give everyone a final opportunity to signal by hitting star one; star one for questions. We'll go next to Tom Zeifang with Lucrum Capital.

Tom Zeifang: Hey, guys. I'm last guy, maybe, so can I rattle off a bunch of questions?

Cesar Garcia: No, you can do one and a follow-up.

Tom Zeifang: Well, I'm just going to hang up and get back.

Donald Mueller: Go and ask your question.

Cesar Garcia: Go and ask your question.

Operator: Yes, sir; please press star one again. Mr. Zeifang, you have reconnected.

Tom Zeifang: Yes, can you hear me?

Cesar Garcia: Yes, I can.

Tom Zeifang: The consumable margin looks a little light versus the first quarter. Can you give us some feedback on that?

Cesar Garcia: Yes, the consumable margin,... the reason is that we delayed all of the activities on the chemistry product line until we got the new iChem100, so Marburg production was lower in terms of volume, in the second quarter than the first quarter.

Donald Mueller: I think there's also an issue there. It's not just consumables; it's consumables and service.

Cesar Garcia: Yes.

Donald Mueller: And so the service level is lower. In the first quarter, we had an unusually high service margin because we had some part shipments that were unusually high internationally. That didn't recur in the second quarter, so that had a quarter-to-quarter trend that had a negative impact.

Tom Zeifang: So, should it, going forward in the back half, should we assume it normalizes?

Cesar Garcia: Yes. I think we will begin to recover margin as we will begin to sell the iChem100 and the vChem because you have the pull through of strips from Marburg. Remember, we bought that businesses on -losing money, and we now are beginning to market the iChem100 and vChem. That will be definitely a significant help on the consumable side. And as Don mentioned, during his formal remarks, we expect to break even in that business during the second quarter of 2007.

Tom Zeifang: And do you think – on the first call you spent a lot of time, a few slides, going over how the annuity stream of consumables were...

Cesar Garcia: Yes.

Tom Zeifang: Anything changed in that model?

Cesar Garcia: No, actually,. if you look in terms of what we reported We have a significant growth in the consumables and service on a quarter to quarter to basis, and this quarter, in comparison to the prior quarter, the consumables increased, I think, by about a half a million; consumables and service.

Tom Zeifang: OK, I'll get in the queue. Thank you.

Cesar Garcia: Thank you.

Operator: And our final question will come from Ernie Andberg with Feltl Company.

Ernie Andberg: Don, did you say that your guidance in the second half contemplated some lower overhead absorption in the cost of sales line?

Don Mueller: It does, and, in fact, and a little bit lower overhead absorption, yes.

Ernie Andberg: And so that you're factoring in some gross margin possible pressure?

Donald Mueller: We're factoring in the level of production that would get our inventory back in line with our guidance. So that's absolutely been considered.

Ernie Andberg: OK. Are you willing to give us some guidance on overall gross margins and sales in general administrative as you have for the 12 percent figure for the R&D spending in the second half?

Donald Mueller: We'd rather not do that. You know I think we gave a lot of information already and you know we would prefer to just stick with the guidance we provided.

Ernie Andberg: Thank you.

Donald Mueller: Thank you.

Operator: Ladies and gentlemen, this concludes today's question and answer session. I would like to turn it back over to your speakers for any additional or closing remarks.

Cesar Garcia: Thank you Keith. I want to thank everyone for participating in the conference call. We have significant plans for the second quarter, and we look forward to a significant recovery in domestic sales and significant improvement during the second half.

Thank you very much, and have a good day.

Operator: Ladies and gentlemen, if you wish to access the replay for this call, you may do so by dialing 1-888-203-1112. For international callers, you need to dial 719-457-0820, and the password ID number is 4350212. This does conclude today's teleconference. We appreciate your participation. You may disconnect your phone lines at this time.

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