
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

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 0-28240

EXACTECH, INC.

(Exact name of registrant as specified in its charter)

FLORIDA

(State or other jurisdiction of
incorporation or organization)

59-2603930

(I.R.S. Employer
Identification No.)

**2320 NW 66TH COURT
GAINESVILLE, FL 32653**

(Address of principal executive offices)

(352) 377-1140

(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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class | Outstanding at November 4, 2011 |
|-------------------------------|---------------------------------|
| Common Stock, \$.01 par value | 13,140,792 |

EXACTECH, INC.

INDEX

| | Page Number |
|---|----------------|
| PART 1. FINANCIAL INFORMATION | |
| Item 1. Condensed Consolidated Financial Statements | |
| Condensed Consolidated Balance Sheets as of September 30, 2011 (unaudited) and December 31, 2010 | 2 |
| Condensed Consolidated Statements of Income (unaudited) for the Three and Nine Month Periods Ended September 30, 2011 and September 30, 2010 | 3 |
| Condensed Consolidated Statement of Changes in Shareholders' Equity and Comprehensive Income (unaudited) for the Nine Month Period Ended September 30, 2011 | 4 |
| Condensed Consolidated Statements of Cash Flows (unaudited) for the Nine Month Periods Ended September 30, 2011 and September 30, 2010 | 5 |
| Notes to Condensed Consolidated Financial Statements (unaudited) for the Three and Nine Month Periods Ended September 30, 2011 and September 30, 2010 | 6 |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | 19 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 32 |
| Item 4. Controls and Procedures | 33 |
| PART II. OTHER INFORMATION | |
| Item 1. Legal Proceedings | 34 |
| Item 1A. Risk Factors | 34 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 34 |
| Item 3. Defaults Upon Senior Securities | 34 |
| Item 5. Other Information | 34 |
| Item 6. Exhibits | 35 |
| Signatures | 36 |

Item 1. Financial Statements

EXACTECH, INC. AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEETS (in thousands)

| | (unaudited) September 30, <u>2011</u> | (audited) December 31, <u>2010</u> |
|---|---|--|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 3,897 | \$ 3,935 |
| Accounts receivable, net of allowances of \$3,010 and \$2,751 | 43,094 | 39,796 |
| Prepaid expenses and other assets, net | 4,899 | 3,384 |
| Income taxes receivable | 727 | 1,544 |
| Inventories – current | 62,788 | 61,602 |
| Deferred tax assets – current | 2,563 | 2,278 |
| Total current assets | <u>117,968</u> | <u>112,539</u> |
| PROPERTY AND EQUIPMENT: | | |
| Land | 2,214 | 2,210 |
| Machinery and equipment | 30,023 | 27,155 |
| Surgical instruments | 72,666 | 60,077 |
| Furniture and fixtures | 3,754 | 3,583 |
| Facilities | 17,984 | 16,365 |
| Projects in process | 1,702 | 3,669 |
| Total property and equipment | <u>128,343</u> | <u>113,059</u> |
| Accumulated depreciation | <u>(52,955)</u> | <u>(44,377)</u> |
| Net property and equipment | 75,388 | 68,682 |
| OTHER ASSETS: | | |
| Deferred financing and deposits, net | 472 | 881 |
| Non-current inventories | 11,866 | 9,191 |
| Product licenses and designs, net | 11,529 | 11,812 |
| Patents and trademarks, net | 1,668 | 1,938 |
| Customer relationships, net | 1,689 | 2,003 |
| Goodwill | 13,461 | 12,947 |
| Total other assets | <u>40,685</u> | <u>38,772</u> |
| TOTAL ASSETS | <u>\$ 234,041</u> | <u>\$ 219,993</u> |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$ 15,025 | \$ 15,855 |
| Income taxes payable | 614 | — |
| Accrued expenses and other liabilities | 7,642 | 8,847 |
| Other current liabilities | 330 | 296 |
| Current portion of long-term debt | 644 | 1,066 |
| Total current liabilities | <u>24,255</u> | <u>26,064</u> |
| LONG-TERM LIABILITIES: | | |
| Deferred tax liabilities | 6,196 | 6,175 |
| Line of credit | 44,591 | 37,556 |
| Long-term debt, net of current portion | 3,669 | 4,153 |
| Other long-term liabilities | 565 | 629 |
| Total long-term liabilities | <u>55,021</u> | <u>48,513</u> |
| Total liabilities | <u>79,276</u> | <u>74,577</u> |
| SHAREHOLDERS' EQUITY: | | |
| Common stock | 131 | 130 |
| Additional paid-in capital | 60,075 | 57,735 |
| Accumulated other comprehensive loss | (2,521) | (2,525) |
| Retained earnings | 97,080 | 90,076 |
| Total shareholders' equity | <u>154,765</u> | <u>145,416</u> |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | <u>\$ 234,041</u> | <u>\$ 219,993</u> |

See notes to condensed consolidated financial statements

EXACTECH, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)
(Unaudited)

| | Three Month Periods Ended September 30, | | Nine Month Periods Ended September 30, | |
|---------------------------------------|--|-----------------|---|-----------------|
| | 2011 | 2010 | 2011 | 2010 |
| NET SALES | \$ 47,278 | \$ 42,023 | \$ 152,329 | \$ 138,693 |
| COST OF GOODS SOLD | 14,898 | 13,704 | 48,156 | 47,810 |
| Gross profit | 32,380 | 28,319 | 104,173 | 90,883 |
| OPERATING EXPENSES: | | | | |
| Sales and marketing | 18,041 | 15,711 | 57,292 | 46,914 |
| General and administrative | 5,070 | 3,850 | 16,555 | 12,427 |
| Research and development | 3,502 | 2,981 | 9,717 | 10,064 |
| Depreciation and amortization | 3,663 | 2,682 | 10,642 | 7,619 |
| Total operating expenses | 30,276 | 25,224 | 94,206 | 77,024 |
| INCOME FROM OPERATIONS | 2,104 | 3,095 | 9,967 | 13,859 |
| OTHER INCOME (EXPENSE): | | | | |
| Interest income | — | 1 | 3 | 3 |
| Other income | 30 | 23 | 73 | 60 |
| Interest expense | (281) | (198) | (821) | (458) |
| Foreign currency exchange (loss) gain | (48) | 852 | 845 | 669 |
| Total other income (expenses) | (299) | 678 | 100 | 274 |
| INCOME BEFORE INCOME TAXES | 1,805 | 3,773 | 10,067 | 14,133 |
| PROVISION FOR INCOME TAXES | 494 | 2,290 | 3,063 | 6,377 |
| NET INCOME | <u>\$ 1,311</u> | <u>\$ 1,483</u> | <u>\$ 7,004</u> | <u>\$ 7,756</u> |
| BASIC EARNINGS PER SHARE | <u>\$ 0.10</u> | <u>\$ 0.11</u> | <u>\$ 0.54</u> | <u>\$ 0.60</u> |
| DILUTED EARNINGS PER SHARE | <u>\$ 0.10</u> | <u>\$ 0.11</u> | <u>\$ 0.53</u> | <u>\$ 0.59</u> |

See notes to condensed consolidated financial statements

EXACTECH, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY
AND COMPREHENSIVE INCOME
(in thousands)
(Unaudited)

| | <u>Common Stock</u> | | <u>Additional Paid-In Capital</u> | <u>Retained Earnings</u> | <u>Accumulated Other Comprehensive Income (Loss)</u> | <u>Total Shareholders' Equity</u> |
|---|---------------------|---------------|---|------------------------------|--|---|
| | <u>Shares</u> | <u>Amount</u> | | | | |
| Balance, December 31, 2010 | 13,028 | \$ 130 | \$ 57,735 | \$ 90,076 | \$ (2,525) | \$ 145,416 |
| Exercise of stock options | 67 | 1 | 600 | — | — | 601 |
| Issuance of restricted common stock for services | 12 | — | 212 | — | — | 212 |
| Issuance of common stock under the Employee Stock Purchase Plan | 33 | — | 461 | — | — | 461 |
| Compensation cost of stock options | — | — | 1,037 | — | — | 1,037 |
| Tax benefit from exercise of stock awards | — | — | 30 | — | — | 30 |
| Comprehensive Income: | | | | | | |
| Net income | — | — | — | 7,004 | — | 7,004 |
| Change in fair value of cash flow hedge, net of tax | — | — | — | — | 17 | 17 |
| Change in currency translation Other comprehensive income | — | — | — | — | (13) | (13) |
| Comprehensive income | | | | | | 4 |
| Comprehensive income | | | | | | 7,008 |
| Balance, September 30, 2011 | <u>13,140</u> | <u>\$ 131</u> | <u>\$ 60,075</u> | <u>\$ 97,080</u> | <u>\$ (2,521)</u> | <u>\$ 154,765</u> |

See notes to condensed consolidated financial statements

EXACTECH, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

| | Nine Month Periods Ended September 30, | |
|---|---|-----------------|
| | 2011 | 2010 |
| OPERATING ACTIVITIES: | | |
| Net income | \$ 7,004 | \$ 7,756 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Provision for allowance for doubtful accounts and sales returns | 259 | 1,361 |
| Inventory allowance | 218 | 665 |
| Depreciation and amortization | 11,876 | 8,727 |
| Restricted common stock issued for services | 212 | 122 |
| Compensation cost of stock awards | 1,037 | 1,349 |
| Tax benefit from exercise of stock options | 30 | 98 |
| Excess tax benefit from exercise of stock options | (30) | (98) |
| Loss on disposal of equipment | 475 | 94 |
| Foreign currency exchange gain | (845) | (669) |
| Deferred income taxes | (276) | 893 |
| Changes in assets and liabilities which provided (used) cash: | | |
| Accounts receivable | (3,361) | (2,801) |
| Prepays and other assets | (1,469) | (1,976) |
| Inventories | (3,606) | (12,463) |
| Accounts payable | (164) | 5,974 |
| Income taxes payable/receivable | 1,437 | (701) |
| Accrued expense & other liabilities | (1,794) | (1,511) |
| Net cash provided by operating activities | 11,003 | 6,820 |
| INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (17,672) | (17,724) |
| Purchase of spine assets | — | (2,578) |
| Purchase of product licenses and designs | (635) | (1,077) |
| Proceeds from sale of equipment | 1 | 3 |
| Purchase of patents and trademarks | — | (167) |
| Acquisition of subsidiary, net of cash acquired | — | (6,221) |
| Net cash used in investing activities | (18,306) | (27,764) |
| FINANCING ACTIVITIES: | | |
| Net borrowings on line of credit | 7,035 | 20,443 |
| Principal payments on debt | (906) | (892) |
| Debt issuance costs | (5) | (41) |
| Excess tax benefit from exercise of stock options | 30 | 98 |
| Proceeds from issuance of common stock | 1,062 | 964 |
| Net cash provided by financing activities | 7,216 | 20,572 |
| Effect of foreign currency translation on cash and cash equivalents | 49 | (35) |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (38) | (407) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 3,935 | 2,889 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 3,897 | \$ 2,482 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Cash paid during the period for: | | |
| Interest | \$ 751 | \$ 333 |
| Income taxes | 2,222 | 7,006 |
| Non-cash investing and financing activities: | | |
| Purchase guarantee payable | 420 | — |
| Spine assets purchase contingency payable | — | 950 |
| Estimated sales and use tax liability | 60 | 976 |
| Cash flow hedge gain (loss), net of tax | 17 | (26) |

See notes to condensed consolidated financial statements

EXACTECH, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE AND NINE MONTH PERIODS ENDED SEPTEMBER 30, 2011 AND 2010
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Exactech, Inc. and its subsidiaries, which are for interim periods, have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission relating to interim financial statements. These unaudited condensed consolidated financial statements do not include all disclosures provided in the annual financial statements. The condensed financial statements should be read in conjunction with the financial statements and notes contained in the Annual Report on Form 10-K for the year ended December 31, 2010 of Exactech, Inc. (the "Company" or "Exactech"), as filed with the Securities and Exchange Commission.

In the opinion of management, all adjustments considered necessary for a fair presentation have been included, consisting of normal recurring adjustments. All adjustments of a normal recurring nature which, in the opinion of management, are necessary to fairly present the results for the interim period have been made. Our subsidiaries, Exactech Asia, Exactech UK, Exactech Japan, France Medica, Exactech Taiwan, Exactech Deutschland, Exactech Iberica, and Exactech International Operations are consolidated for financial reporting purposes, and all intercompany balances and transactions have been eliminated. Results of operations for the three and nine month period ended September 30, 2011 are not necessarily indicative of the results to be expected for the full year.

Certain amounts reported for prior periods have been reclassified to be consistent with the current period presentation.

2. NEW ACCOUNTING PRONOUNCEMENTS AND STANDARDS

In September 2011, the Financial Accounting Standards Board ("FASB") amended its goodwill guidance that provides companies the option to first perform a qualitative assessment whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If the company determines that this is the case, it is required to perform the currently prescribed two step goodwill impairment test. The amendment is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. The adoption of this updated authoritative guidance is not expected to have a significant impact on the company's Condensed Consolidated Financial Statements.

In June 2011, the FASB amended its guidance on the presentation of comprehensive income in financial statements. This new guidance will require companies to present the components of net income and other comprehensive income either as one continuous statement or as two consecutive statements, eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. The new guidance is required retroactively, effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. We are currently evaluating the impact of adopting this guidance on our financial statements.

In May 2011, the FASB amended its guidance on fair value measurements and related disclosures. This new guidance is issued as part of the convergence project between U.S. GAAP and International Financial Reporting Standards (IFRS) on the requirements for measurement of and disclosures about fair value, and results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between IFRS and U.S. GAAP. The new guidance also changes certain fair value measurement principles and enhances the disclosure requirements related to activities in Level 3 of the fair value hierarchy. The amendment is effective for interim and annual periods beginning after December 15, 2011. The adoption of this updated authoritative guidance is not expected to have a significant impact on the company's Condensed Consolidated Financial Statements.

3. FAIR VALUE MEASURES

Our financial instruments include cash and cash equivalents, trade receivables, debt and cash flow hedges. The carrying amounts of cash and cash equivalents, and trade receivables approximate fair value due to their short maturities. The carrying amount of debt approximates fair value due to the variable rate associated with the debt. The fair values of cash flow hedges are based on dealer quotes.

Certain financial assets and liabilities are accounted for at fair value, which is defined as 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. The following fair value hierarchy prioritizes the inputs used to measure fair value:

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 – Pricing inputs are other than quoted prices in active markets included in level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies.

Level 3 – Pricing inputs include significant inputs that are generally less observable from objective sources. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value from the perspective of a market participant.

The table below provides information on our liabilities that are measured at fair value on a recurring basis:

| (In Thousands) | <u>Total Fair Value at September 30, 2011</u> | <u>Quoted Prices in Active Markets (Level 1)</u> | <u>Significant Other Observable Inputs (Level 2)</u> | <u>Significant Unobservable Inputs (Level 3)</u> |
|--------------------|---|--|--|--|
| Interest Rate Swap | \$ 191 | \$ — | \$ 191 | \$ — |
| Total | <u>\$ 191</u> | <u>\$ —</u> | <u>\$ 191</u> | <u>\$ —</u> |

The fair value of our interest rate swap agreement is based on dealer quotes, and is recorded as accumulated other comprehensive loss in the consolidated balance sheets. We analyze the effectiveness of our interest rate swap on a quarterly basis, and, for the period ended September 30, 2011, we have determined the interest rate swap to be effective.

4. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill – The following table provides the changes to the carrying value of goodwill for the period ended September 30, 2011 (in thousands):

| | <u>Knee</u> | <u>Hip</u> | <u>Biologics and Spine</u> | <u>Extremities</u> | <u>Other</u> | <u>Total</u> |
|--------------------------------------|-----------------|------------|--------------------------------|--------------------|--------------|---------------|
| Balance as of December 31, 2010 | \$ 3,572 | \$ 601 | \$ 7,553 | \$ 393 | \$ 828 | \$ 12,947 |
| Acquired goodwill | 192 | 42 | — | 49 | 137 | 420 |
| Foreign currency translation effects | 42 | 18 | — | 11 | 23 | 94 |
| Balance as of September 30, 2011 | <u>\$ 3,806</u> | <u>661</u> | <u>\$ 7,553</u> | <u>\$ 453</u> | <u>988</u> | <u>13,461</u> |

We test goodwill for impairment annually as of the 1st of October. Our impairment analysis during the fourth quarter of 2010 indicated no impairment to goodwill.

Other Intangible Assets – The following tables summarize our carrying values of our other intangible assets at September 30, 2011 and December 31, 2010 (in thousands):

| | Carrying Value | Accumulated Amortization | Net Carrying Value | Weighted Avg Amortization Period |
|-------------------------------|---------------------------|-------------------------------------|-------------------------------|---|
| Balance at September 30, 2011 | | | | |
| Product licenses and designs | \$ 14,600 | \$ 3,071 | \$ 11,529 | 10.7 |
| Customer relationships | 3,152 | 1,463 | 1,689 | 7.0 |
| Patents and trademarks | 4,063 | 2,395 | 1,668 | 13.0 |
| Balance at December 31, 2010 | | | | |
| Product licenses and designs | \$ 13,967 | \$ 2,155 | \$ 11,812 | 10.7 |
| Customer relationships | 3,109 | 1,106 | 2,003 | 7.0 |
| Patents and trademarks | 4,092 | 2,154 | 1,938 | 12.9 |

5. FOREIGN CURRENCY TRANSLATION AND HEDGING ACTIVITIES

Foreign Currency Translation – We are exposed to market risk related to changes in foreign currency exchange rates. The functional currency of substantially all of our international subsidiaries is the local currency. Transactions are translated into U.S. dollars and exchange gains and losses arising from translation are recognized in “Other comprehensive income (loss)”. Fluctuations in exchange rates affect our financial position and results of operations. The majority of our foreign currency exposure is to the Euro (EUR), British Pound (GBP), and Japanese Yen (JPY). During the nine months ended September 30, 2011, translation losses were \$13,000. During the nine months ended September 30, 2010, translation losses were \$366,000, which were due to the weakening of the EUR. We may experience translation gains and losses during the year ending December 31, 2011; however, these gains and losses are not expected to have a material effect on our financial position, results of operations, or cash flows. Gains and losses resulting from our transactions and our subsidiaries’ transactions, which are made in currencies different from their own, are included in income as they occur and as other income (expense) in the Condensed Consolidated Statements of Income. We recognized currency transaction gains of \$845,000 for the nine months ended September 30, 2011 and currency transaction gains of \$669,000 for the nine months ended September 30, 2010.

Other Comprehensive Income (Loss) – Other comprehensive income (loss) is comprised of unrealized gains or losses from the change in fair value of certain derivative instruments, and for foreign currency translation effects. The following table provides information on the components of our other comprehensive loss (in thousands):

| | Cash Flow Hedge | Foreign Currency Translation | Total |
|----------------------------|----------------------------|---|-------------------|
| Balance December 31, 2010 | \$ (134) | \$ (2,391) | \$ (2,525) |
| 2011 Adjustments | 17 | (13) | 4 |
| Balance September 30, 2011 | <u>\$ (117)</u> | <u>\$ (2,404)</u> | <u>\$ (2,521)</u> |

We do not enter into or hold derivative instruments for trading or speculative purposes. We entered into our interest rate swap to eliminate variability in future cash flows by converting LIBOR-based variable-rate interest payments into fixed-rate interest payments. The fair value of our interest rate swap agreement is based on dealer quotes, and the change in fair value is recorded as accumulated other comprehensive loss in the consolidated balance sheets. We do not expect the change in our interest rate swap to have a material impact on our results of operations, financial position or cash flows.

6. INVENTORIES

Inventories are valued at the lower of cost or market and include implants consigned to customers and agents. We also provide significant loaned implant inventory to non-distributor customers. The consigned or loaned inventory remains our inventory until we are notified of the implantation. We are also required to maintain substantial levels of inventory as it is necessary to maintain all sizes of each component to fill customer orders. The size of the component to be used for a specific patient is typically not known with certainty until the time of surgery. Due to this uncertainty, a minimum of one of each size of each component in the system to be used must be available to each sales representative at the time of surgery. As a result of the need to maintain substantial levels of inventory, we are subject to the risk of inventory obsolescence. In the event that a substantial portion of our inventory becomes obsolete, it would have a material adverse effect on the Company. Allowance charges for obsolete and slow moving inventories are recorded based upon an analysis of specific identification of obsolete inventory items and quantification of slow moving inventory items. For slow moving inventory, this analysis compares the quantity of inventory on hand to the projected sales of such inventory items. As a result of this analysis, we record an estimated allowance for slow moving inventory. Due to the nature of the slow moving inventory, this allowance may fluctuate up or down, as a charge or recovery. Allowance changes for the three and nine months ended September 30, 2011 were \$(172,000) and \$218,000, respectively. Allowance changes for the three and nine months ended September 30, 2010 were \$686,000 and \$665,000, respectively. We also test our inventory levels for the amount of inventory that would be sold within one year. At certain times, as we stock new subsidiaries, add consignment locations, and launch new products, the level of inventory can exceed the forecasted level of cost of goods sold for the next twelve months. As of September 30, 2011, we determined that \$11.9 million of inventory should be classified as non-current. As of December 31, 2010, we determined that \$9.2 million of inventory should be classified as non-current.

The following table summarizes our classifications of inventory as of September 30, 2011 and December 31, 2010 (in thousands):

| | 2011 | 2010 |
|------------------------------------|-----------|-----------|
| Raw materials | \$ 17,690 | \$ 17,180 |
| Work in process | 1,015 | 1,192 |
| Finished goods on hand | 24,232 | 24,268 |
| Finished goods on loan/consignment | 31,717 | 28,153 |
| Inventory total | 74,654 | 70,793 |
| Non-current inventories | 11,866 | 9,191 |
| Inventories, current | \$ 62,788 | \$ 61,602 |

7. ACQUISITION AND DISTRIBUTION SUBSIDIARY START-UPS

Acquisition of Spine Assets

Effective August 27, 2010, we acquired the inventory, instruments and design licenses for several innovative spine product lines from VertiFlex, Inc., a leading developer of minimally invasive and motion preserving spinal surgery technologies. The VertiFlex products were acquired to enhance our current product offering for minimally invasive spinal surgery procedures. We also acquired the customer list related to the acquired products. We initially paid \$2.5 million in cash for these assets, with two contingent consideration payments for a potential maximum of an additional \$1.0 million payable in cash. As part of the acquisition terms of the spine assets acquired from VertiFlex, Inc., two contingent consideration payables were recorded. The first contingent consideration for \$500,000 was paid upon VertiFlex completing certain regulatory matters prior to the end of 2010. The second contingent consideration was for an additional payable based on our achieving certain sales targets during the six month period following the date of close. The range of contingent earn-out payment was \$150,000 for the minimum U.S. sales and \$500,000 for the maximum sales goal. During March 2011, we paid \$250,000 in settlement of that contingency, of which, in December 2010 we had \$300,000 in contingencies payable

recorded based on our estimated probability of completing the earn-out contingency measures. We paid closing fees of approximately \$78,000.

Acquisition of Brighton Partners

Effective May 24, 2010, we completed the 100% acquisition of our supplier, Brighton Partners, Inc., the sole source supplier for our net compression molded (NCM) polyethylene bearings for our Optetrak[®] knee system. Our purchase price at closing was \$5.5 million dollars in cash, paid to the shareholders of Brighton in exchange for their shares of common stock in Brighton. We financed the acquisition through our existing line of credit. Accounts payable of \$99,000 to Brighton Partners related to our supplier relationship was eliminated at acquisition. We identified and recognized an intangible asset for the technology process valued at \$4.8 million, which management has determined to be the principal asset acquired. We recognized \$2.0 million in goodwill.

Prior to acquisition, Brighton Partners was deemed to be 24% beneficially owned by Albert H. Burstein, Ph.D., a director of the Company. Additionally, William Petty, Chairman of the Board and Chief Executive Officer of the Company, and Betty Petty, Secretary of the Company, jointly owned 4.6% of Brighton Partners. Gary J. Miller, Executive Vice President of the Company, beneficially owned 2.8% of Brighton Partners. Other executive officers of the Company owned less than 3% of Brighton Partners, Inc. No member of Exactech's management had control over, or influenced the operations of, Brighton Partners.

We have an oral consulting agreement with Albert Burstein, Ph.D., to provide services regarding many facets of the orthopaedic industry including product design rationale, manufacturing and development techniques and product sales and marketing. This agreement is terminable at will by either party. Pursuant to this agreement, we paid Dr. Burstein \$180,000 each year in 2010, 2009 and 2008, as compensation under the consulting agreement. The consulting agreement continues post acquisition.

Acquisition of Germany Assets

Effective April 1, 2010, we completed the acquisition of certain assets of Tantum AG, our prior independent distributor in Germany, which was accomplished to obtain a certain hip product line and to maintain access to a large European market with an established workforce and existing customers. Our purchase price at closing was approximately 1 million EUR, or \$1.35 million translated at the March 31, 2010 exchange rate of \$1.35 per 1.00 EUR. Consideration paid was in the form of 410,000 EUR in cash and 563,000 EUR in forgiven accounts receivable that were owed to us as of March 31, 2010. We recognized an intangible customer relationship of \$193,000, and goodwill of \$695,000. We financed the acquisition through our existing line of credit.

Acquisition of France Medica

Effective April 1, 2008, we completed the acquisition of our French distributor, France Medica. The total purchase price of approximately \$10.3 million was paid, in a combination of cash and Exactech common stock, to certain shareholders of France Medica over a three year period. The final contingent installment for a translated amount of \$420,000, based on the exchange rate as of the end of June of \$1.44 per 1.00 EUR, was released in the third quarter of 2011, and was recorded in goodwill, as additional cost of the acquisition, on our consolidated balance sheets, as of June 30, 2011. As of September 30, 2011, we recognized goodwill of \$3.1 million for the acquisition and currency translation effect of \$(221,000), for a final adjustment to goodwill of \$2.9 million.

New International Operations Center – Exactech International Operations

During 2010, we established an international sales office in Switzerland, to manage the international sales and marketing efforts for our foreign subsidiaries. In January 2011, we renamed our international sales office to Exactech International Operations, AG ("EIO"), and relocated the office to Bern, Switzerland, as part of our realignment of our foreign subsidiaries and operations. The equity ownership of our foreign subsidiaries, with the exception of our Chinese operations, was transferred to EIO. EIO also acquired certain licenses to our intangibles to allow the use of our intellectual property outside the U.S. These actions have been undertaken to streamline and consolidate our international operations with the expectation of achieving improved customer service, cost savings, and international tax efficiency.

Distribution Subsidiary – Exactech Iberica

During the first quarter of 2010, we established a distribution subsidiary in Spain, Exactech Iberica, S.A.U. (“Exactech Iberica”). The sales distribution subsidiary, based in Gijon, enables us to directly control our Spanish marketing and distribution operations. We obtained our import registration to allow Exactech Iberica to import our products for sale in Spain and actively commenced distribution activities during the third quarter of 2010. During the first quarter of 2010, we notified our existing independent distributor in Spain of the non-renewal of our distribution agreement. As a result of that non-renewal, our relationship terminated during the third quarter of 2010. We expect a return of product from the former distributor, and as a result we have a sales return allowance of approximately \$1.3 million recorded against accounts receivable for this distributor on the consolidated balance sheet as of September 30, 2011.

8. INCOME TAX

At December 31, 2010, net operating loss carry forwards of our foreign and domestic subsidiaries totaled \$34.8 million, some of which begin to expire in 2013. For accounting purposes, the estimated tax effect of these net operating loss carry forwards results in a deferred tax asset. This deferred tax asset was \$9.2 million at December 31, 2010; however, a valuation allowance of \$4.6 million was charged against this deferred tax asset assuming these losses will not be fully realized. At September 30, 2011, these loss carry forwards totaled \$37.8 million, and the deferred tax asset associated with these losses was \$10.2 million with a valuation allowance of \$6.2 million charged against this deferred tax asset assuming these losses will not be fully realized.

9. DEBT

Debt consists of the following at September 30, 2011 and December 31, 2010 (in thousands):

| | <u>2011</u> | <u>2010</u> |
|---|------------------|------------------|
| Commercial construction loan payable in monthly principal installments of \$17.5, plus interest based on adjustable rate as determined by one month LIBOR (1.73% as of September 30, 2011); proceeds used to finance expansion of current facility | \$ 2,358 | \$ 2,515 |
| Commercial equipment loan payable in monthly principal installments of \$49.5, beginning November 2006, plus interest based on adjustable rate as determined by one month LIBOR with a minimum floor of 5.58%; proceeds used to finance equipment for production facility expansion | — | 443 |
| Commercial real estate loan payable in monthly installments of \$46.4, including principal and interest based on an adjustable rate as determined by one month LIBOR, fixed by a swap agreement with the lender at 6.61% as a cash flow hedge. Proceeds used to remodel facilities and restructure portion of debt. | 1,955 | 2,261 |
| Business line of credit payable on a revolving basis, plus interest based on adjustable rate as determined by one month LIBOR based on our ratio of funded debt to EBITDA (2.57% for the accordion portion and 1.97% for the remainder, as of September 30, 2011). Proceeds used to fund working capital. | 44,591 | 37,556 |
| Total debt | 48,904 | 42,775 |
| Less current portion | (644) | (1,066) |
| | <u>\$ 48,260</u> | <u>\$ 41,709</u> |

The following is a schedule of debt maturities as of September 30, 2011, for the years ended December 31:

| | | | |
|------------|-------|----|---------------|
| 2011 | | \$ | 158 |
| 2012 | | | 651 |
| 2013 | | | 45,272 |
| 2014 | | | 713 |
| 2015 | | | 643 |
| Thereafter | | | 1,467 |
| | | \$ | <u>48,904</u> |

10. COMMITMENTS AND CONTINGENCIES

Litigation

There are various claims, lawsuits, and disputes with third parties and pending actions involving various allegations against us incident to the operation of our business, principally product liability cases. We are currently a party to several product liability suits related to the products distributed by us on behalf of RTI Biologics, Inc., or RTI. Pursuant to our license and distribution agreement with RTI, we will tender all cases to RTI. While we believe that the various claims are without merit, we are unable to predict the ultimate outcome of such litigation. We therefore maintain insurance, subject to self-insured retention limits, for all such claims, and establish accruals for product liability and other claims based upon our experience with similar past claims, advice of counsel and the best information available. At September 30, 2011, we had \$50,000 accrued for product liability claims and as of December 31, 2010, we did not have any accruals for product liability claims. These matters are subject to various uncertainties, and it is possible that they may be resolved unfavorably to us. However, while it is not possible to predict with certainty the outcome of the various cases, it is the opinion of management that, upon ultimate resolution, the cases will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Our insurance policies covering product liability claims must be renewed annually. Although we have been able to obtain insurance coverage concerning product liability claims at a cost and on other terms and conditions that are acceptable to us, we may not be able to procure acceptable policies in the future.

On December 7, 2010, we entered into a twelve-month Deferred Prosecution Agreement, or DPA, with the United States Attorney's Office for the District of New Jersey, or the USAO, and a five year Corporate Integrity Agreement, or CIA, with the Office of the Inspector General of the United States Department of Health and Human Services. The foregoing agreements, together with a related settlement agreement, resolve the investigation commenced by the USAO in December 2007 into our consulting arrangements with orthopaedic surgeons relating to our hip and knee products in the United States, which we refer to as the Subject Matter. As set forth in the DPA, the USAO specifically acknowledges that it does not allege that our conduct adversely affected patient health or patient care. Pursuant to the DPA, the USAO has agreed not to prosecute us in connection with the Subject Matter provided that we comply with our obligations under the DPA during its term. Additionally, pursuant to the DPA, an independent monitor will review and evaluate our compliance with our obligations under the DPA monitorship. CIA acknowledges the existence of our corporate compliance program and provides us with certain other compliance-related obligations during the CIA's term. See "Item 1A — Risk Factors" for more information about our obligations under these agreements. We continue to enhance and apply our corporate compliance program, and we monitor our practices on an ongoing basis to ensure that we have in place proper controls necessary to comply with applicable laws in the jurisdictions in which we do business. Our failure to maintain compliance with U.S. healthcare regulatory laws could expose us to significant liability including, but not limited to, extension of the term of the DPA, exclusion from federal healthcare program participation, including Medicaid and Medicare, civil and criminal fines or penalties, and additional litigation cost and expense. Pursuant to the CSA, we settled civil and administrative claims relating to the matter for a payment of \$3.0 million, without any admission by the Company. We previously accrued

approximately \$3.5 million for an anticipated settlement and legal expenses related to this investigation, and therefore, these agreements did not materially impact our results of operations.

On October 18, 2010, MBA Incorporado, S.L., or MBA, our former distributor in Spain filed an action against Exactech, Inc. and Exactech Ibérica, S.A.U. in the Court of First Instance No. 10 of Gijon, Spain in connection with our termination of the distribution agreement with MBA in July 2010. In the lawsuit, MBA alleges, (i) wrongful solicitation of certain employees of MBA subsequent to the termination of the distribution agreement, (ii) breach of contract with respect to the termination date established by Exactech and Exactech's alleged failure to follow the termination transitioning protocols set forth in the distribution agreement, and (iii) commercial damages and lost sales and customers due to Exactech's alleged failure to supply products requested by MBA during the transition period of the distribution agreement termination. In the Complaint 1 filing MBA seeks damages of forty-four million (€44,000,000) Euros compensation for all benefits alleged to be owed by Exactech under the distribution agreement, including alleged loss of clientele, alleged loss of prestige and credibility, alleged loss of client confidence and alleged illegitimate business practices. On December 1, 2010, MBA filed a second action ("Complaint 2") against Exactech Iberica and two of the former principals of MBA, in the Mercantile Court No. 3 of Gijon, Spain, also in connection with our termination of the distribution agreement with MBA in July 2010, seeking among other things injunctive relief. In March 2011, the court dismissed injunctive relief as requested by MBA in Complaint 2. Both complaints are currently working through the legal proceedings process, but the second one has been suspended until such time as the first lawsuit receives final and definitive resolution. While it is not possible to predict with certainty the outcome of the lawsuit, we believe that our termination of the distribution agreement with MBA was proper, all actions taken by us in connection with the termination (including during the transition period) were proper and, accordingly, the claims are without merit and subject to a number of defenses we possess. We intend to vigorously defend ourselves against these claims.

Purchase Commitments

At September 30, 2011, we had outstanding commitments for the purchase of inventory, raw materials and supplies of \$11.3 million and outstanding commitments for the purchase of capital equipment of \$0.7 million. Purchases under our distribution agreements were \$5.5 million during the nine months ended September 30, 2011.

Our Taiwanese subsidiary, Exactech Taiwan, has entered into a license agreement with the Industrial Technology Research Institute (ITRI) and the National Taiwan University Hospital (NTUH) for the rights to technology and patents related to the repair of cartilage lesions. As of September 30, 2011, we have paid approximately \$1.5 million for the licenses, patents, and equipment related to this license agreement, and we will make royalty payments when the technology becomes marketable. Using the technology, we plan to launch a cartilage repair program that will include a device and method for the treatment and repair of cartilage in the knee joint. It is expected that the project will require us to complete human clinical trials under the guidance of the Food & Drug Administration in order to obtain pre-market approval for the device in the United States. The agreement terms include a license fee based on the achievement of specific, regulatory milestones and a royalty arrangement based on sales once regulatory clearances are established.

Contingencies

As of September 30, 2011, we recorded a contingent liability of \$1.0 million based on the estimated weighted probability of the outcome of a claim by the State of Florida for sales and use tax, based on the State's audit of such tax dating back to May 2005, which was assessed by the State of Florida for the value of surgical instruments removed from inventory and capitalized as property and equipment worldwide. In consultation with counsel, management is challenging the assessment; however, there can be no assurances that we will ultimately prevail in our challenge against the assessment. In evaluating the contingent liability, management followed the FASB guidance on contingencies, and concluded that the contingent liability is probable, based on verbal assertions by Florida Department of Revenue personnel, and can be reasonably estimated, however if we are unsuccessful in our challenge against the

State of Florida, we could have a maximum potential liability of \$2.9 million for the tax period audited through September 30, 2011. Any use tax determined to be due and payable to the Florida Department of Revenue will increase the basis of the surgical instruments, and this amount will be amortized over the remaining useful life of the instruments.

11. SEGMENT INFORMATION

We evaluate our operating segments by our major product lines: knee implants, hip implants, biologics and spine, extremity implants and other products. The “other products” segment includes miscellaneous sales categories, such as surgical instruments held for sale, bone cement, instrument rental fees, shipping charges, and other implant product lines. Evaluation of the performance of operating segments is based on their respective income from operations before taxes, interest income and expense, and nonrecurring items. Intersegment sales and transfers are not significant. The accounting policies of the reportable segments are the same as those described in Note 2 of the notes to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2010.

Total assets not identified with a specific segment are listed as “corporate” and include cash and cash equivalents, accounts receivable, income taxes receivable, deposits and prepaid expenses, deferred tax assets, land, facilities, office furniture and computer equipment, notes receivable, and other investments. Depreciation and amortization on corporate assets is allocated to the product segments for purposes of evaluating the income (loss) from operations, and capitalized surgical instruments are allocated to the appropriate product line supported by those assets.

Total gross assets held outside the United States as of September 30, 2011, was \$34.9 million. Included in these assets is \$21.8 million in surgical instrumentation, stated gross as it is impracticable to account for depreciation on these assets by region.

Summarized information concerning our reportable segments is shown in the following table (in thousands):

| (in thousands) | Knee | Hip | Biologics & Spine | Extremity | Other | Corporate | Total |
|--|-----------|-----------|----------------------|-----------|-----------|-----------|------------|
| Three months ended September 30, 2011 | | | | | | | |
| Net sales | \$ 17,908 | \$ 7,990 | \$ 5,415 | \$ 9,780 | \$ 6,185 | \$ — | \$ 47,278 |
| Segment profit (loss) | 2,650 | (136) | (143) | 345 | (612) | (299) | 1,805 |
| Total assets, net | 62,380 | 31,445 | 22,020 | 16,336 | 8,872 | 92,988 | 234,041 |
| Capital expenditures | 1,420 | 597 | 284 | 913 | 21 | 691 | 3,926 |
| Depreciation and Amortization | 1,351 | 592 | 354 | 287 | 116 | 1,362 | 4,062 |
| 2010 | | | | | | | |
| Net sales | \$ 15,619 | \$ 6,561 | \$ 6,343 | \$ 7,317 | \$ 6,183 | \$ — | \$ 42,023 |
| Segment profit (loss) | 2,151 | 117 | 287 | 1,590 | (1,050) | 678 | 3,773 |
| Total assets, net | 62,551 | 26,036 | 25,160 | 12,319 | 5,910 | 76,650 | 208,625 |
| Capital expenditures | 4,051 | 871 | — | 810 | 185 | 2,772 | 8,689 |
| Depreciation and Amortization | 1,178 | 439 | 240 | 180 | 69 | 976 | 3,082 |
| Nine months ended September 30, 2011 | | | | | | | |
| Net sales | \$ 59,946 | \$ 24,393 | \$ 18,423 | \$ 28,874 | \$ 20,693 | \$ — | \$ 152,329 |
| Segment profit (loss) | 7,195 | 579 | 516 | 3,624 | (1,947) | 100 | 10,067 |
| Total assets, net | 62,380 | 31,445 | 22,020 | 16,336 | 8,872 | 92,988 | 234,041 |
| Capital expenditures | 5,591 | 3,692 | 1,452 | 2,400 | 1,519 | 3,653 | 18,307 |
| Depreciation and Amortization | 4,143 | 1,659 | 968 | 773 | 364 | 3,969 | 11,876 |
| 2010 | | | | | | | |
| Net sales | \$ 55,893 | \$ 20,509 | \$ 20,539 | \$ 21,478 | \$ 20,274 | \$ — | \$ 138,693 |
| Segment profit (loss) | 7,792 | 1,048 | 1,739 | 5,596 | (2,316) | 274 | 14,133 |
| Total assets, net | 62,551 | 26,036 | 25,160 | 12,319 | 5,910 | 76,650 | 208,625 |
| Capital expenditures | 8,891 | 2,366 | 9 | 1,443 | 402 | 6,657 | 19,768 |
| Depreciation and Amortization | 3,289 | 1,378 | 629 | 568 | 242 | 2,621 | 8,727 |

Geographic distribution of our sales is summarized in the following table (in thousands):

| Three months ended September 30, | 2011 | 2010 | % Inc (Decr) |
|---|-------------------|-------------------|---------------------|
| Domestic sales | \$ 31,451 | \$ 31,868 | (1.3) |
| International sales | 15,827 | 10,155 | 55.9 |
| Total sales | <u>\$ 47,278</u> | <u>\$ 42,023</u> | <u>12.5</u> |
| Nine months ended September 30, | | | |
| | 2011 | 2010 | % Inc (Decr) |
| Domestic sales | \$ 99,049 | \$ 97,481 | 1.6 |
| International sales | 53,280 | 41,212 | 29.3 |
| Total sales | <u>\$ 152,329</u> | <u>\$ 138,693</u> | <u>9.8</u> |

12. SHAREHOLDERS' EQUITY

The following is a reconciliation of the numerators and denominators of the basic and diluted EPS computations for net income and net income available to common shareholders (in thousands, except per share amounts):

| | Three Months Ended September 30, 2011 | | | Three Months Ended September 30, 2010 | | |
|--|--|------------------------------|----------------|--|------------------------------|----------------|
| | Income (Numer- ator) | Shares (Denom- inator) | Per Share | Income (Numer- ator) | Shares (Denom- inator) | Per Share |
| Net income | \$ 1,311 | | | \$ 1,483 | | |
| Basic EPS: | | | | | | |
| Net income available to common shareholders | \$ 1,311 | 13,125 | <u>\$ 0.10</u> | \$ 1,483 | 12,908 | <u>\$ 0.11</u> |
| Effect of dilutive securities: | | | | | | |
| Stock options | | <u>82</u> | | <u>141</u> | | |
| Diluted EPS: | | | | | | |
| Net income available to common shareholders plus assumed conversions | \$ 1,311 | 13,207 | <u>\$ 0.10</u> | \$ 1,483 | 13,049 | <u>\$ 0.11</u> |
| | | | | | | |
| | Nine Months Ended September 30, 2011 | | | Nine Months Ended September 30, 2010 | | |
| | Income (Numer- ator) | Shares (Denom- inator) | Per Share | Income (Numer- ator) | Shares (Denom- inator) | Per Share |
| Net income | \$ 7,004 | | | \$ 7,756 | | |
| Basic EPS: | | | | | | |
| Net income available to common shareholders | \$ 7,004 | 13,083 | <u>\$ 0.54</u> | \$ 7,756 | 12,879 | <u>\$ 0.60</u> |
| Effect of dilutive securities: | | | | | | |
| Stock options | | <u>132</u> | | <u>202</u> | | |
| Diluted EPS: | | | | | | |
| Net income available to common shareholders plus assumed conversions | \$ 7,004 | 13,215 | <u>\$ 0.53</u> | \$ 7,756 | 13,081 | <u>\$ 0.59</u> |

For the three months ended September 30, 2011, weighted average options to purchase 789,448 shares of common stock at exercise prices ranging from \$15.89 to \$26.43 per share were outstanding but were not included in the computation of diluted EPS because the options were antidilutive under the treasury stock method. For the three months ended September 30, 2010, weighted average options to purchase 726,635 shares of common stock at exercise prices ranging from \$15.89 to \$26.43 per share were outstanding but were not included in the computation of diluted EPS because the options were antidilutive under the treasury stock method.

For the nine months ended September 30, 2011, weighted average options to purchase 519,424 shares of common stock at exercise prices ranging from \$17.15 to \$26.43 per share were outstanding but were not included in the computation of diluted EPS because the options were antidilutive under the treasury stock method. For the nine months ended September 30, 2010, weighted average options to purchase 448,236 shares of common stock at exercise prices ranging from \$18.10 to \$26.43 per share were outstanding but were not included in the computation of diluted EPS because the options were antidilutive under the treasury stock method.

Stock-based Compensation Awards:

We sponsor an Executive Incentive Compensation Plan, which provides for the award of stock-based compensation, including options, stock appreciation rights, restricted stock and other stock-based incentive compensation awards to key employees, directors and independent agents and consultants. We implemented a comprehensive, consolidated incentive compensation plan upon shareholder approval at our Annual Meeting of Shareholders on May 7, 2009, referred to as the 2009 Plan, which replaced the 2003 incentive compensation plan. An amendment to the 2009 Plan was approved at the 2011 Annual Meeting of Shareholders on June 9, 2011 to increase the maximum number of shares issuable from 500,000 to 1,000,000. The maximum number of common shares issuable under the 2009 Plan is 1,000,000 shares plus any remaining shares issuable under the 2003 plan. The terms of the 2009 Plan are substantially similar to the terms of the 2003 Plan. Common stock issued upon exercise of stock options is settled with authorized but unissued shares available. Under the plans, the exercise price of option awards equals the market price of our stock on the date of grant, and has a maximum term of ten years. As of September 30, 2011, there were 823,707 total remaining shares issuable under the 2009 Plan.

The compensation cost that has been charged against income for the Plan and 2009 Employee Stock Purchase Plan, or 2009 ESPP, was \$1,037,000 and \$1,349,000 and income tax benefit of \$234,000 and \$282,000 for the nine months ended September 30, 2011 and 2010, respectively. Included in the above compensation cost is non-employee stock compensation expense of approximately \$1,000 and \$7,000, net of taxes, during the nine months ended September 30, 2011 and 2010, respectively. As of September 30, 2011, total unrecognized compensation cost related to unvested awards was \$665,000 and is expected to be recognized over a weighted-average period of 0.86 years.

Stock Options:

A summary of the status of stock option activity under our stock-based compensation plans as of September 30, 2011 and changes during the nine months ended September 30, 2011 is presented below:

| | 2011 | | | |
|---|------------------|-----------------------------|---|--|
| | Shares | Weighted Avg Exercise Price | Weighted Avg Remaining Contractual Term | Aggregate Intrinsic Value (In thousands) |
| Options | | | | |
| Outstanding – January 1 | 1,379,256 | \$ 15.79 | | |
| Granted | 74,700 | 18.93 | | – |
| Exercised | (67,254) | 8.94 | | 602 |
| Forfeited or Expired | (42,664) | 12.72 | | |
| Outstanding – September 30 | <u>1,344,038</u> | <u>16.40</u> | <u>3.28</u> | <u>546</u> |
| Exercisable – September 30 | <u>996,335</u> | <u>16.20</u> | <u>2.88</u> | <u>497</u> |
| Weighted average fair value per share of options vested during the nine months | | <u>\$ 7.07</u> | | |
| Weighted average fair value per share of options granted during the nine months | | <u>\$ 8.23</u> | | |

Outstanding options, consisting of five-year to ten-year incentive stock options, vest and become exercisable ratably over a three to five year period from the date of grant. The outstanding options expire from five to ten years from the date of grant or upon retirement from Exactech, and are contingent upon continued employment during the applicable option term. Certain non-qualified stock options are granted to non-employee sales agents and consultants, and they typically vest ratably over a period of three to four years from the date of grant and expire in five years or less from the date of grant, or upon termination of the agent or consultant's contract with Exactech. There were 74,700 shares of stock options granted during the nine months ended September 30, 2011. There were 327,060 shares of stock options granted during the nine months ended September 30, 2010, which included options to purchase 133,421 shares of common stock granted pursuant to the employment agreement with our chief executive officer.

Restricted Stock Awards:

Under the plans, we may grant restricted stock awards to eligible employees, directors, and independent agents and consultants. Restrictions on transferability, risk of forfeiture and other restrictions are determined by the Compensation Committee of the Board of Directors ("Committee") at the time of the award. During March 2011, the Committee approved equity compensation to the six outside members of the Board of Directors for their service on the Board of Directors. The compensation for each director was for the grant of stock awards to each director with an annual market value of \$50,000, payable in the form of four equal quarterly grants of common stock based on the market price at the dates of grant. The summary information of the restricted stock grants for the first nine months of 2011 is presented below:

| Grant date | <u>March 4, 2011</u> | <u>May 31, 2011</u> | <u>August 31, 2011</u> |
|--|----------------------|---------------------|------------------------|
| Aggregate shares of restricted stock granted | 4,044 | 3,990 | 4,215 |
| Grant date fair value | \$ 75,000 | \$ 75,000 | \$ 62,000 |
| Weighted average fair value per share | \$ 18.53 | \$ 18.78 | \$ 14.82 |

During December 2009, the Committee approved equity compensation to the five outside members of the Board of Directors for their service on the Board of Directors. The compensation for each director was for either the grant of stock awards to each director with an annual market value of \$50,000, payable in the form of four equal quarterly grants of common stock based on the market price at the dates of grant, or an option to purchase common stock, the choice being at the discretion of each individual director. Pursuant to the approved grant, four of our outside directors chose to receive the restricted stock awards. The first one-third of the compensation was granted on December 1, 2009 and the remaining two-thirds of the compensation was payable during 2010 in four equal quarterly grants. The summary information of the restricted stock grants, as of September 30, 2010, is presented below:

| Grant date | <u>December 1, 2009</u> | <u>February 26, 2010</u> | <u>May 28, 2010</u> | <u>August 31, 2010</u> |
|--|-------------------------|--------------------------|---------------------|------------------------|
| Aggregate shares of restricted stock granted | 4,192 | 1,716 | 2,564 | 3,065 |
| Grant date fair value | \$ 67,000 | \$ 33,000 | \$ 44,000 | \$ 44,000 |
| Weighted average fair value per share | \$ 15.89 | \$ 19.39 | \$ 17.33 | \$ 14.51 |

All of the restricted stock awards in 2011 and 2010 were considered fully vested at each of the grant dates. The restricted stock awards require no service period and thus, no risk or provision for forfeiture.

Employee Stock Purchase Plan:

On February 18, 2009, our board of directors adopted the Exactech, Inc. 2009 Employee Stock Purchase Plan, which we refer to as the 2009 ESPP. Our shareholders approved this new 2009 ESPP at our Annual Meeting of Shareholders on May 7, 2009. Under the 2009 ESPP, employees are allowed to purchase shares of our common stock at a fifteen percent (15%) discount via payroll deduction. There are four offering periods during an annual period. There are 150,000 shares reserved for issuance under the plan. As of September 30, 2011, 58,640 shares remain available to purchase under this 2009 ESPP. The fair value of the employee's purchase rights is estimated using the Black-Scholes model. Purchase information and fair value assumptions are presented in the following table:

| Nine months ended September 30, | <u>2011</u> | <u>2010</u> |
|--|-------------|-------------|
| Shares purchased | 33,265 | 29,420 |
| Dividend yield | — | — |
| Expected life | 1 year | 1 year |
| Expected volatility | 40% | 52% |
| Risk free interest rates | 2.9% | 3.7% |
| Weighted average per share fair value | \$ 4.21 | \$ 4.65 |

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the unaudited condensed consolidated financial statements and related notes appearing elsewhere in this report.

Overview of the Company

We develop, manufacture, market and sell orthopaedic implant devices, related surgical instrumentation, supplies and biologic materials to hospitals and physicians in the United States and internationally. Our revenues are principally derived from sales of knee, hip, and extremity joint replacement systems and spinal fusion products. Revenue from the worldwide distribution of biologic materials contributes to our total reported sales and has been a key component of growth over the last few years. Our continuing research and development projects will enable us to continue the introduction of new, advanced biologic materials and other products and services. Revenue from sales of other products, including surgical instrumentation, Cemex[®] bone cement, the InterSpace[™] pre-formed, antibiotic cement hip, knee and shoulder spacers have contributed to revenue growth and are expected to continue to be an important part of our anticipated future revenue growth.

Our operating expenses consist of sales and marketing expenses, general and administrative expenses, research and development expenses, and depreciation expenses. The largest component of operating expenses, sales and marketing expenses, primarily consists of payments made to independent sales representatives for their services to hospitals and surgical facilities on our behalf. These expenses tend to be variable in nature and related to sales growth. Research and development expenses primarily consist of expenditures on projects concerning knee, extremities, spine and hip implant product lines and biologic materials and services.

In marketing our products, we use a combination of traditional targeted media marketing together with our primary marketing focus, direct customer contact and service to orthopaedic surgeons. Because surgeons are the primary decision maker when it comes to the choice of products and services that best meet the needs of their patients, our marketing strategy is focused on meeting the needs of the orthopaedic surgeon community. In addition to surgeon's preference, hospitals and buying groups, as the economic customer, are actively participating with physicians in the choice of implants and services.

Overview of the Three and Nine Months Ended September 30, 2011

During the quarter ended September 30, 2011, sales increased 13% to \$47.3 million from \$42.0 million in the comparable quarter ended September 30, 2010, as we continued to gain market share in our large joint product segments and experienced a positive currency impact of approximately \$1.0 million. Gross margins increased to 68.5% from 67.4% as a result of our expanded direct distribution operations internationally. Operating expenses increased 20% from the quarter ended September 30, 2010, and as a percentage of sales, operating expenses increased to 64% during the third quarter of 2011 as compared to 60% for the same quarter in 2010. This increase, as a percentage of sales, was primarily due to additional expenses related to our new distribution offices in Spain and Germany, as well as compliance and legal costs associated with the monitorship of the DPA agreement entered into with the Department of Justice, or DOJ, of \$951,000 in the third quarter of 2011, which increased from \$216,000 of related DOJ inquiry expenses in the third quarter of 2010. Net income for the quarter ended September 30, 2011 decreased 12% to \$1.3 million, and diluted earnings per share were \$0.10 as compared to \$0.11 last year.

During the nine months ended September 30, 2011, sales increased 10% to \$152.3 million from \$138.7 million in the comparable nine months ended September 30, 2010, as we continued to gain market share in our large joint product segments. Gross margins increased to 68.4% from 65.5% as a result of our growth in our international direct distribution subsidiaries. Operating expenses increased 22% from the nine months ended September 30, 2010, and, as a percentage of sales, operating expenses increased to 62% during the first nine months of 2011 as compared to 56% for the same period in 2010. This increase, as a percentage of sales, was primarily due to the additional expenses related to our new distribution

offices, and to an increase in compliance and legal costs to \$3.7 million in the first nine months of 2011 from \$795,000 in the first nine months of 2010 as a result of higher compliance costs associated with the DPA agreement with the DOJ. Net income for the nine months ended September 30, 2011 decreased 10% to \$7.0 million, and diluted earnings per share were \$0.53 as compared to \$0.59 last year.

During the nine months ended September 30, 2011, we acquired \$17.7 million in property and equipment, including new production equipment and surgical instrumentation. Cash flow from operations was \$11.0 million for the nine months ended September 30, 2011 as compared to a net cash flow from operations of \$6.8 million during the nine months ended September 30, 2010.

The following table includes the net sales and percentage of net sales for each of our product lines for the three month periods ended September 30, 2011 and September 30, 2010:

| Sales by Product Line (dollars in thousands) | | | | | |
|--|---------------------------|---------------|---------------------------|---------------|---------------|
| | Three Months Ended | | | | Change |
| | September 30, 2011 | | September 30, 2010 | | |
| Knee Products | \$ 17,908 | 37.9% | \$ 15,619 | 37.2% | 14.7% |
| Hip Products | 7,990 | 16.9 | 6,561 | 15.6 | 21.8 |
| Biologics & Spine | 5,415 | 11.4 | 6,343 | 15.1 | (14.6) |
| Extremity | 9,780 | 20.7 | 7,317 | 17.4 | 33.7 |
| Other Products | 6,185 | 13.1 | 6,183 | 14.7 | — |
| Total | \$ 47,278 | 100.0% | \$ 42,023 | 100.0% | 12.5% |

| | Nine Months Ended | | | | Change |
|-------------------|---------------------------|---------------|---------------------------|---------------|---------------|
| | September 30, 2011 | | September 30, 2010 | | |
| Knee Products | \$ 59,946 | 39.3% | \$ 55,893 | 40.3% | 7.3% |
| Hip Products | 24,393 | 16.0 | 20,509 | 14.8 | 18.9 |
| Biologics & Spine | 18,423 | 12.1 | 20,539 | 14.8 | (10.3) |
| Extremity | 28,874 | 19.0 | 21,478 | 15.5 | 34.4 |
| Other Products | 20,693 | 13.6 | 20,274 | 14.6 | 2.1 |
| Total | \$ 152,329 | 100.0% | \$ 138,693 | 100.0% | 9.8% |

The following table includes items from the unaudited Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2011 as compared to the three and nine months ended September 30, 2010, the dollar and percentage change from period to period and the percentage relationship to net sales (dollars in thousands):

Comparative Statement of Income Data

| | Three Months Ended | | 2011 – 2010 | | % of Sales | |
|-------------------------------|---------------------------|-----------|--------------------|---------|-------------------|--------|
| | September 30, | | Inc (decr) | | 2011 2010 | |
| | 2011 | 2010 | \$ | % | 2011 | 2010 |
| Net sales | \$ 47,278 | \$ 42,023 | 5,255 | 12.5 | 100.0% | 100.0% |
| Cost of goods sold | 14,898 | 13,704 | 1,194 | 8.7 | 31.5 | 32.6 |
| Gross profit | 32,380 | 28,319 | 4,061 | 14.3 | 68.5 | 67.4 |
| Operating expenses: | | | | | | |
| Sales and marketing | 18,041 | 15,711 | 2,330 | 14.8 | 38.2 | 37.4 |
| General and administrative | 5,070 | 3,850 | 1,220 | 31.7 | 10.7 | 9.1 |
| Research and development | 3,502 | 2,981 | 521 | 17.5 | 7.4 | 7.1 |
| Depreciation and amortization | 3,663 | 2,682 | 981 | 36.6 | 7.7 | 6.4 |
| Total operating expenses | 30,276 | 25,224 | 5,052 | 20.0 | 64.0 | 60.0 |
| Income from operations | 2,104 | 3,095 | (991) | (32.0) | 4.5 | 7.4 |
| Other (expenses) income, net | (299) | 678 | (977) | (144.1) | (0.7) | 1.6 |
| Income before taxes | 1,805 | 3,773 | (1,968) | (52.2) | 3.8 | 9.0 |
| Provision for income taxes | 494 | 2,290 | (1,796) | (78.4) | 1.0 | 5.5 |
| Net income | \$ 1,311 | \$ 1,483 | (172) | (11.6) | 2.8 | 3.5 |

| | Nine Months Ended September 30, | | 2011 – 2010 Inc (decr) | | % of Sales | |
|-------------------------------|------------------------------------|------------|---------------------------|--------|------------|---------|
| | 2011 | 2010 | \$ | % | 2011 | 2010 |
| Net sales | \$ 152,329 | \$ 138,693 | 13,636 | 9.8 | 100.0 % | 100.0 % |
| Cost of goods sold | 48,156 | 47,810 | 346 | 0.7 | 31.6 | 34.5 |
| Gross profit | 104,173 | 90,883 | 13,290 | 14.6 | 68.4 | 65.5 |
| Operating expenses: | | | | | | |
| Sales and marketing | 57,292 | 46,914 | 10,378 | 22.1 | 37.6 | 33.8 |
| General and administrative | 16,555 | 12,427 | 4,128 | 33.2 | 10.9 | 9.0 |
| Research and development | 9,717 | 10,064 | (347) | (3.4) | 6.4 | 7.3 |
| Depreciation and amortization | 10,642 | 7,619 | 3,023 | 39.7 | 7.0 | 5.4 |
| Total operating expenses | 94,206 | 77,024 | 17,182 | 22.3 | 61.9 | 55.5 |
| Income from operations | 9,967 | 13,859 | (3,892) | (28.1) | 6.5 | 10.0 |
| Other (expenses) income, net | 100 | 274 | (174) | (63.5) | 0.1 | 0.2 |
| Income before taxes | 10,067 | 14,133 | (4,066) | (28.8) | 6.6 | 10.2 |
| Provision for income taxes | 3,063 | 6,377 | (3,314) | (52.0) | 2.0 | 4.6 |
| Net income | \$ 7,004 | \$ 7,756 | (752) | (9.7) | 4.6 | 5.6 |

Three and Nine Months Ended September 30, 2011 Compared to Three and Nine Months Ended September 30, 2010

Sales

For the quarter ended September 30, 2011, total sales increased 13% to \$47.3 million from \$42.0 million in the comparable quarter ended September 30, 2010. Sales of knee implant products increased 15% to \$17.9 million for the quarter ended September 30, 2011 compared to \$15.6 million for the quarter ended September 30, 2010, as we continued the introduction of our Logic PS™ knee system. Hip implant sales of \$8.0 million during the quarter ended September 30, 2011 increased 22% over the \$6.6 million in sales during the quarter ended September 30, 2010, as we continued to experience market penetration with our Novation Element™ hip system. Sales from biologics and spine decreased 15% during the quarter ended September 30, 2011 to \$5.4 million, down from \$6.3 million in the comparable quarter in 2010, primarily as a result of increased competition and general economic pressure. Sales of our extremity products were up 34% to \$9.8 million as compared to \$7.3 million for the same period in 2010, as our Equinoxe® shoulder systems, including the reverse and platform fracture stem line extensions, continue their increasing market acceptance. Sales of all other products remained flat at \$6.2 million for each of the quarters ended September 30, 2011 and 2010. Domestically, total sales decreased 1% to \$31.5 million, or 67% of total sales, during the quarter ended September 30, 2011, down from \$31.9 million, which represented 76% of total sales, in the comparable quarter last year. Internationally, total sales increased 56% to \$15.8 million, representing 33% of total sales, for the quarter ended September 30, 2011, as compared to \$10.2 million, or 24% of total sales, for the same quarter in 2010.

For the nine months ended September 30, 2011, total sales increased 10% to \$152.3 million from \$138.7 million in the comparable nine months ended September 30, 2010. Sales of knee implant products increased 7% to \$59.9 million for the nine months ended September 30, 2011 compared to \$55.9 million for the nine months ended September 30, 2010. Hip implant sales of \$24.4 million during the nine months ended September 30, 2011 increased 19% over the \$20.5 million in sales during the nine months ended September 30, 2010, as our Element hip systems continue to receive market acceptance. Sales from biologics and spine decreased 10% during the nine months ended September 30, 2011 to \$18.4 million, from \$20.5 million in the comparable nine months in 2010. Sales of our extremity products were up 34% to \$28.9 million as compared to \$21.5 million for the same period in 2010, as we continue to see increasing market acceptance of our Equinoxe® reverse shoulder system. Sales of all other products increased to \$20.7 million as compared to \$20.3 million in the same nine month period last year. Domestically, total sales increased 2% to \$99.0 million, or 65% of total sales, during the nine months ended September 30, 2011, up from \$97.5 million, which represented 70% of total sales, in the comparable nine months last year. Internationally, total sales increased 29% to \$53.3 million, representing 35% of total sales, for the nine months ended September 30, 2011, as compared to \$41.2 million, which was 30% of total sales, for the same period in 2010.

Gross Profit

Gross profit increased 14% to \$32.4 million in the quarter ended September 30, 2011 from \$28.3 million in the quarter ended September 30, 2010. As a percentage of sales, gross profit increased to 68.5% during the quarter ended September 30, 2011 as compared to 67.4% in the quarter ended September 30, 2010, primarily as a result of higher growth in our international direct selling operations which result in higher margins than our international independent distributor business.

Gross profit increased 15% to \$104.2 million in the nine months ended September 30, 2011 from \$90.9 million in the nine months ended September 30, 2010. As a percentage of sales, gross profit increased to 68.4% during the nine months ended September 30, 2011 as compared to 65.5% in the nine month period ended September 30, 2010, as a result of growth in both our domestic market and international direct markets, which generally results in higher margin sales. Looking forward, for the fourth quarter of 2011, we expect gross profit, as a percentage of sales, to be 0.5-1.0% higher than prior year quarter on a comparative quarter basis.

Operating Expenses

Total operating expenses increased 20% to \$30.3 million in the quarter ended September 30, 2011 from \$25.2 million in the quarter ended September 30, 2010. As a percentage of sales, total operating expenses increased to 64% for the quarter ended September 30, 2011, as compared to 60% for the same period in 2010. The increase in operating expenses was principally due to increased expenses from our new distribution operations in Spain, increased research and development activities and increased Health Care Professional, or HCP, compliance expenditures related to the DPA monitorship. Total operating expenses increased 22% to \$94.2 million in the nine months ended September 30, 2011 from \$77.0 million in the nine months ended September 30, 2010. As a percentage of sales, total operating expenses increased to 62% for the nine months ended September 30, 2011, as compared to 56% for the same period in 2010. Included in operating expenses for the first nine months in 2011 is \$3.7 million in compliance costs related to the DPA monitorship, as compared to \$795,000 in DOJ inquiry expenses incurred in the first nine months of 2010. The increase as a percentage of sales was primarily due to the increased operating expenses from our new subsidiaries as well as the increase in compliance costs.

Sales and marketing expenses, the largest component of total operating expenses, increased 15% for the quarter ended September 30, 2011 to \$18.0 million from \$15.7 million in the same quarter last year, as we continue to expand our global marketing efforts through our new subsidiaries, of which expenses in Spain, Germany and Japan contributed \$1.8 million of the increase. Sales and marketing expenses, as a percentage of sales increased to 38% for the quarter ended September 30, 2011, from 37% for the quarter ended September 30, 2010. Sales and marketing expenses increased 22% for the nine months ended September 30, 2011 to \$57.3 million from \$46.9 million in the same period last year. Sales and marketing expenses, as a percentage of sales increased to 38% for the nine months ended September 30, 2011, from 34% for the nine months ended September 30, 2010, primarily due to our increases in expenditures from expanding our international distribution network. Looking forward, sales and marketing expenditures, as a percentage of sales, are expected to be in the range of 36% to 38% for the fourth quarter of 2011.

General and administrative expenses increased 32% to \$5.1 million in the quarter ended September 30, 2011 from \$3.9 million in the quarter ended September 30, 2010, which included the \$0.9 million and \$0.2 million in expenses related to the DPA monitorship and DOJ inquiry for each of the periods, respectively. As a percentage of sales, general and administrative expenses increased to 11% for the quarter ended September 30, 2011, as compared to 9% in the quarter ended September 30, 2010. Excluding the compliance related expenses, general and administrative expenses remained at 9% of sales for both years. General and administrative expenses increased 33% to \$16.6 million in the nine months ended September 30, 2011 from \$12.4 million in the nine months ended September 30, 2010, which included the \$3.7 million and \$0.8 million in expenses related to the DPA monitorship and DOJ inquiry for each of the periods, respectively. As a percentage of sales, general and administrative expenses increased to 11% for the nine months ended September 30, 2011, as compared to 9% in the nine months ended September 30,

2010. Excluding the DOJ expenses, general and administrative expenses were flat at 8% of sales for the nine month period for both years. General and administrative expenses for the fourth quarter ending December 31, 2011 are expected to be in the range of 8% to 9%, as a percentage of sales, excluding the impact of compliance expenses.

Research and development expenses increased 17% for the quarter ended September 30, 2011 to \$3.5 million from \$3.0 million in the same quarter last year, as we incurred increased design input costs from our surgeon consultants as compared to the first half of the year. As a percentage of sales, research and development expenses remained at 7% for each of the quarters ended September 30, 2011 and 2010. Research and development expenses decreased 3% for the nine months ended September 30, 2011 to \$9.7 million from \$10.1 million in the same period last year. As a percentage of sales, research and development expenses decreased to 6% for the nine months ended September 30, 2011 from 7% for the comparable nine months last year. We anticipate growth in research and development expenditures to continue to keep pace with sales growth as increases in product development and consulting expenses for the fourth quarter are expected, with total research and development expenses ranging from 7% to 8% of sales.

Depreciation and amortization increased 37% to \$3.7 million during the quarter ended September 30, 2011 from \$2.7 million in the quarter ended September 30, 2010, primarily as a result of continuing investment in our manufacturing capabilities and surgical instrumentation. As a percentage of sales, depreciation and amortization increased to 8% for the third quarter of 2011, compared to 6% during the quarter ended September 30, 2010. Depreciation and amortization increased 40% to \$10.6 million during the nine months ended September 30, 2011 from \$7.6 million in the nine months ended September 30, 2010. As a percentage of sales, depreciation and amortization increased to 7% for the nine month period ended September 30, 2011, compared to 5% during the nine month period ended September 30, 2010 as we continued to invest in surgical instrumentation to support global distribution expansion and product launches. We placed \$14.7 million of surgical instrumentation in service, \$4.3 million in manufacturing equipment and facilities, and spent \$635,000 for product licenses and designs during the first nine months of 2011.

Income from Operations

Our income from operations decreased 32% to \$2.1 million, or 4% of sales in the quarter ended September 30, 2011 from \$3.1 million, or 7% of sales in the quarter ended September 30, 2010. The reduction is partially due to increased sales and marketing expenses related to the expansion of our international direct distribution operations, as well as the \$951,000 in expenses for the HCP compliance program. Excluding the impact of these HCP compliance program expenses during the third quarter of 2011, and \$216,000 during the third quarter of 2010, income from operations for the quarter ended September 30, 2011, decreased 8% to \$3.1 million from \$3.3 million adjusted income from operations during the third quarter of 2010. Our income from operations decreased 28% to \$10.0 million, or 7% of sales in the nine months ended September 30, 2011 from \$13.9 million, or 10% of sales in the nine month period ended September 30, 2010. Excluding the impact of the HCP compliance expenses of \$3.7 million recognized during the first nine months of 2011, and \$795,000 during the first nine months of 2010, income from operations for the nine months ended September 30, 2011, decreased 7% to \$13.7 million from \$14.7 million adjusted income from operations during the same nine months of 2010. Looking forward, we expect to continue to experience increases in compliance costs greater than sales growth and therefore we anticipate income from operations to be in the range of 7 - 9% for the fourth quarter of 2011.

Other Income and Expenses

We had other expenses, net of other income, of \$299,000 during the quarter ended September 30, 2011, as compared to other income, net of other expenses of \$678,000 in the quarter ended September 30, 2010, primarily due to currency transaction losses during the quarter, and by increased net interest expense for the quarter ended September 30, 2011 of \$281,000 as compared to \$198,000 during the quarter ended September 30, 2010. We had other income, net of other expenses, of \$100,000 during the

nine months ended September 30, 2011, as compared to other, income net of other expenses of \$274,000 in the nine months ended September 30, 2010, primarily due to gains related to foreign currency transactions during the first nine months of 2011, partially offset by an increase in net interest expense for the nine months ended September 30, 2011 to \$821,000 as compared to \$458,000 during the nine months ended September 30, 2010, due to increased borrowing under our line of credit facility.

Taxes and Net Income

Income before provision for income taxes decreased 52% to \$1.8 million in the quarter ended September 30, 2011 from \$3.8 million in the quarter ended September 30, 2010. The effective tax rate, as a percentage of income before taxes, was 27% for the quarter ended September 30, 2011 and 61% for the quarter ended September 30, 2010. As a result of the foregoing, we realized net income of \$1.3 million in the quarter ended September 30, 2011, a decrease of 12% from \$1.5 million in the quarter ended September 30, 2010. As a percentage of sales, net income decreased to 3% for the quarter ended September 30, 2011 from 4% for the quarter ended September 30, 2010. Earnings per share, on a diluted basis, decreased to \$0.10 for quarter ended September 30, 2011 from \$0.11 for the quarter ended September 30, 2010. Income before provision for income taxes decreased 29% to \$10.1 million in the nine months ended September 30, 2011 from \$14.1 million in the nine months ended September 30, 2010. The effective tax rate, as a percentage of income before taxes, was 30% for the nine months ended September 30, 2011 and 45% for the nine months ended September 30, 2010. The decrease in the effective tax rate for the first nine months of the year was primarily due to the tax impact of our international restructuring of our sales and marketing operations as well as the research and development tax credit that was effective in the first nine months of 2011 as opposed to it having expired during the first nine months of 2010. We expect our effective tax rates to range from 31% to 33% for the balance of 2011. As a result of the foregoing, we realized net income of \$7.0 million in the nine months ended September 30, 2011, a decrease of 10% from \$7.8 million in the nine months ended September 30, 2010. As a percentage of sales, net income decreased to 5% for the nine months ended September 30, 2011 as compared to 6% for the first nine months of 2010. Earnings per share, on a diluted basis, decreased to \$0.53 for nine months ended September 30, 2011, from \$0.59 for the nine months ended September 30, 2010.

Non-GAAP Financial Measures

In addition to providing results that are determined in accordance with accounting principles generally accepted in the United States, referred to as GAAP, we have provided certain financial measures that are not in accordance with GAAP. Our non-GAAP financial results and metrics of sales and operating expenses on a constant currency basis are provided to assist investors in the comparison of our operating performance without the impact of currency exchange fluctuations related to our operations where the functional currency is not in USD. Financial results and metrics that are adjusted for constant currency are calculated by restating current period activity into USD using the comparable prior period's foreign currency exchange rates. Our non-GAAP financial measures of adjusted net income and adjusted diluted earnings per share exclude the charges we incurred in relation to the DOJ inquiry in 2010 and the DPA related monitorship and enhanced HCP compliance program costs in 2011, less the tax effect of the charges. Because the DOJ inquiry and DPA related monitorship costs are unique events, not directly related to our normal operations, we believe these non-GAAP financial measures may help investors better understand and compare our quarterly operating results and trends by eliminating the unusual components included in GAAP financial measures.

The following table compares the total percent increase in sales by product line for the three and nine months ended September 30, 2011 from the three and nine month periods ended September 30, 2010, per U.S. GAAP sales compared to sales calculated on a constant currency basis.

| | Three Month Change | | Nine Month Change | |
|-------------------|--------------------|-------------------|-------------------|-------------------|
| | U.S. GAAP | Constant Currency | U.S. GAAP | Constant Currency |
| Knee Products | 14.7% | 11.8% | 7.3% | 5.6% |
| Hip Products | 21.8 | 19.0 | 18.9 | 17.2 |
| Biologics & Spine | (14.6) | (15.7) | (10.3) | (11.0) |
| Extremity | 33.7 | 32.6 | 34.4 | 33.8 |
| Other Products | — | (3.1) | 2.1 | 0.2 |
| Total | 12.5 | 10.2 | 9.8 | 8.4 |

Adjustments to operating expenses for constant currency impact and HCP related expenses for the three and nine month periods ended September 30, 2011 and 2010, are reconciled below (in thousands):

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|-----------------------------|----------------------------------|-----------|-------------|---------------------------------|-----------|-------------|
| | 2011 | 2010 | Incr/(Decr) | 2011 | 2010 | Incr/(Decr) |
| Total operating expense | \$ 30,276 | \$ 25,224 | 20.0% | \$ 94,206 | \$ 77,024 | 22.3% |
| Constant currency impact | (839) | | | (2,061) | | |
| | 29,437 | 25,224 | 16.7 | 92,145 | 77,024 | 19.6 |
| HCP related expenses | (951) | (216) | | (3,692) | (795) | |
| Adjusted operating expenses | \$ 28,486 | \$ 25,008 | 13.9 | \$ 88,453 | \$ 76,229 | 16.0 |

Excluding the impact of the pre-tax expenses of \$951,000 for the management of our HCP compliance program and other DPA monitorship related expenses recognized during the third quarter of 2011, and \$216,000 during the third quarter of 2010, income from operations for the quarter ended September 30, 2011, decreased 8% to \$3.1 million from \$3.3 million adjusted income from operations during the third quarter of 2010. Adjusted net income for the quarter ended September 30, 2011, increased 19% to \$1.9 million, as compared to an adjusted 2010 net income of \$1.6 million, also adjusted for DOJ inquiry expenses incurred during the same quarter of 2010. Adjusted diluted earnings per share for the third quarter of 2011 increased to \$0.15 compared to adjusted diluted earnings per share of \$0.12 for the third quarter of 2010. Excluding the impact of the pre-tax expenses of \$3.7 million for management of our HCP compliance and other DPA monitorship related expenses recognized during the first nine months of 2011, and \$795,000 during the first nine months of 2010, income from operations for the nine months ended September 30, 2011, decreased 7% to \$13.7 million from \$14.7 million adjusted income from operations during the same nine months of 2010. Adjusted net income for the nine months ended September 30, 2011, increased 13% to \$9.4 million, as compared to an adjusted 2010 net income of \$8.3 million, adjusted also for DOJ inquiry expenses incurred during the same period of 2010. Adjusted diluted earnings per share for first nine months of 2011 increased to \$0.71 as compared to adjusted diluted earnings per share of \$0.63 for the first nine months of 2010.

The reconciliations of these non-GAAP financial measures are as follows (in thousands, except per share amounts):

| | Three Month Period Ended September 30, | | Nine Month Period Ended September 30, | |
|---|---|-----------------|--|------------------|
| | 2011 | 2010 | 2011 | 2010 |
| Income from operations | \$ 2,104 | \$ 3,095 | \$ 9,967 | \$ 13,859 |
| HCP compliance expenses, pre-tax | 951 | 216 | 3,692 | 795 |
| Adjusted income from operations - excluding HCP compliance expenses | <u>\$ 3,055</u> | <u>\$ 3,311</u> | <u>\$ 13,659</u> | <u>\$ 14,654</u> |
| | | | | |
| | Three Month Period Ended September 30, | | Nine Month Period Ended September 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| Net Income | \$ 1,311 | \$ 1,483 | \$ 7,004 | \$ 7,756 |
| Adjustments for HCP compliance expenses: | | | | |
| HCP compliance expenses, pre-tax | 951 | 216 | 3,692 | 795 |
| Income tax benefit | (329) | (80) | (1,343) | (294) |
| Adjustments, net of tax | 622 | 136 | 2,349 | 501 |
| Adjusted net income - excluding HCP compliance expenses | <u>\$ 1,933</u> | <u>\$ 1,619</u> | <u>\$ 9,353</u> | <u>\$ 8,257</u> |
| | | | | |
| Diluted earnings per share | \$ 0.10 | \$ 0.11 | \$ 0.53 | \$ 0.59 |
| Adjustment of HCP compliance expenses, net | 0.05 | 0.01 | 0.18 | 0.04 |
| Adjusted diluted earnings per share | <u>\$ 0.15</u> | <u>\$ 0.12</u> | <u>\$ 0.71</u> | <u>\$ 0.63</u> |

The weighted-average diluted shares outstanding used in the calculation of these non-GAAP financial measures are the same as the weighted-average shares outstanding used in the calculation of the reported per share amounts.

Liquidity and Capital Resources

We have financed our operations through a combination of commercial debt financing, equity issuances and cash flows from our operating activities. At September 30, 2011, we had working capital of \$93.7 million, an increase of 8% from \$86.5 million at the end of 2010. Working capital in 2011 increased primarily as a result of an increase in accounts receivable as well as our inventory build associated with product line and market expansions. We experienced overall increases in our current assets due to our growth. We project that cash flows from operating activities, borrowing under our existing line of credit, and issuance of equity securities, from stock purchases under the employee stock purchase plan and stock option exercises, will be sufficient to meet our commitments and cash requirements in the following twelve months. If not, we will seek additional funding options with any number of possible combinations of additional debt, additional equity or convertible debt.

Operating Activities - Operating activities provided net cash of \$11.0 million in the nine months ended September 30, 2011, as compared to net cash from operations of \$6.8 million during the nine months ended September 30, 2010. A primary contributor to this change related to lower increases in our inventory, and offset partially by our increase in accounts receivable and decrease in accounts payable during the first nine months of 2011. Our allowance for doubtful accounts and sales returns increased to \$3.0 million at September 30, 2011 from \$2.8 million at December 31, 2010. Included in the accounts receivable allowances in the comparable periods is an estimated sales return, net of cost of goods sold, of \$1.3 million related to the nonrenewal of our agreement with our Spanish independent distributor. We cannot give assurances that the transitioning to direct sales outside the U.S. will not result in a larger amount of returned products with a corresponding increase in this allowance. The total days sales outstanding (DSO) ratio, based on average accounts receivable balances, was 73 for the nine months

ended September 30, 2011, up from a ratio of 66 for the nine months ended September 30, 2010. As we continue to expand our operations internationally, our DSO ratio could continue to increase, due to the fact that credit terms outside the U.S. tend to be relatively longer than those in the U.S. Inventory was increased by \$3.6 million during the first nine months ended September 30, 2011, compared to an increase of \$12.5 million during the same period ended September 30, 2010, due to a completion in the initial stocking of our direct distribution market expansions during 2010. The decrease in accounts payable for the nine months ended September 30, 2011 used aggregate net cash of \$0.2 million, in contrast to net cash provided of \$6.0 million for the nine months ended September 30, 2010.

Investing Activities - Investing activities used net cash of \$18.3 million in the nine months ended September 30, 2011, as compared to \$27.8 million in the nine months ended September 30, 2010. The decrease was due to our cash outlay of \$17.7 million for purchases of surgical instrumentation, manufacturing equipment, and facility expansion, and \$635,000 for purchases of product licenses during the nine months ended September 30, 2011 as compared to activity during the same period of 2010 resulting in cash outlay of \$17.7 million for purchases of surgical instrumentation and manufacturing equipment, \$1.2 million for purchases of product licenses, patents and trademarks, and \$8.8 million for a business combination and asset acquisition.

Acquisition of Spine Assets

Effective August 27, 2010, we acquired the inventory, instruments and design licenses for several innovative spine product lines from VertiFlex, Inc., a leading developer of minimally invasive and motion preserving spinal surgery technologies. The VertiFlex products were acquired to enhance our current product offering for minimally invasive spinal surgery procedures. We also acquired the customer list related to the acquired products. We initially paid \$2.5 million in cash for these assets, with two contingent consideration payments for a potential maximum of an additional \$1.0 million payable in cash. As part of the acquisition terms of the spine assets acquired from VertiFlex, Inc., two contingent consideration payables were recorded. The first contingent consideration for \$500,000 was paid upon VertiFlex completing certain regulatory matters prior to the end of 2010. The second contingent consideration was for an additional payable based on our achieving certain sales targets during the six month period following the date of close. The range of contingent earn-out payment was \$150,000 for the minimum U.S. sales and \$500,000 for the maximum sales goal. During March 2011, we paid \$250,000 in settlement of that contingency, of which, in December 2010 we had \$300,000 in contingencies payable recorded based on our estimated probability of completing the earn-out contingency measures. We paid closing fees of approximately \$78,000.

Acquisition of Brighton Partners

Effective May 24, 2010, we completed the 100% acquisition of our supplier, Brighton Partners, Inc., the sole source supplier for our net compression molded (NCM) polyethylene bearings for our Optetrak[®] knee system. Our purchase price at closing was \$5.5 million dollars in cash, paid to the shareholders of Brighton in exchange for their shares of common stock in Brighton. We financed the acquisition through our existing line of credit. Accounts payable of \$99,000 to Brighton Partners related to our supplier relationship was eliminated at acquisition. We identified and recognized an intangible asset for the technology process valued at \$4.8 million, which management has determined to be the principal asset acquired. We recognized \$2.0 million in goodwill.

Prior to acquisition, Brighton Partners was deemed to be 24% beneficially owned by Albert H. Burstein, Ph.D., a director of the Company. Additionally, William Petty, Chairman of the Board and Chief Executive Officer of the Company, and Betty Petty, Secretary of the Company, jointly owned 4.6% of Brighton Partners. Gary J. Miller, Executive Vice President of the Company, beneficially owned 2.8% of Brighton Partners. Other executive officers of the Company owned less than 3% of Brighton Partners, Inc. No member of Exactech's management had control over, or influenced the operations of, Brighton Partners.

We have an oral consulting agreement with Albert Burstein, Ph.D., to provide services regarding many facets of the orthopaedic industry including product design rationale, manufacturing and development techniques and product sales and marketing. This agreement is terminable at will by either party.

Pursuant to this agreement, we paid Dr. Burstein \$180,000 each year in 2010, 2009 and 2008, as compensation under the consulting agreement. The consulting agreement continues post acquisition.

Acquisition of Germany Assets

Effective April 1, 2010, we completed the acquisition of certain assets of Tantum AG, our prior independent distributor in Germany, which was accomplished to obtain a certain hip product line and to maintain access to a large European market with an established workforce and existing customers. Our purchase price at closing was approximately 1 million EUR, or \$1.35 million translated at the March 31, 2010 exchange rate of \$1.35 per 1.00 EUR. Consideration paid was in the form of 410,000 EUR in cash and 563,000 EUR in forgiven accounts receivable that were owed to us as of March 31, 2010. We recognized an intangible customer relationship of \$193,000, and goodwill of \$695,000. We financed the acquisition through our existing line of credit.

Acquisition of France Medica

Effective April 1, 2008, we completed the acquisition of our French distributor, France Medica. The total purchase price of approximately \$10.3 million was paid, in a combination of cash and Exactech common stock, to certain shareholders of France Medica over a three year period. The final contingent installment for a translated amount of \$420,000, based on the exchange rate as of the end of June of \$1.44 per 1.00 EUR, was released in the third quarter of 2011, and was recorded in goodwill, as additional cost of the acquisition, on our consolidated balance sheets, as of June 30, 2011. As of September 30, 2011, we recognized goodwill of \$3.1 for the acquisition and currency translation effect of \$(221,000), for a final adjustment to goodwill of \$2.9 million.

New International Operations Center – Exactech International Operations

During 2010, we established an international sales office in Switzerland, to manage the international sales and marketing efforts for our foreign subsidiaries. In January 2011, we renamed our international sales office to Exactech International Operations, AG (“EIO”), and relocated the office to Bern, Switzerland, as part of our realignment of our foreign subsidiaries and operations. The equity ownership of our foreign subsidiaries, with the exception of our Chinese operations, was transferred to EIO. EIO also acquired certain licenses to our intangibles to allow the use of our intellectual property outside the U.S. These actions have been undertaken to streamline and consolidate our international operations with the expectation of achieving improved customer service, cost savings, and international tax efficiency.

Distribution Subsidiary – Exactech Iberica

During the first quarter of 2010, we established a distribution subsidiary in Spain, Exactech Iberica, S.A.U. (“Exactech Iberica”). The sales distribution subsidiary, based in Gijon, enables us to directly control our Spanish marketing and distribution operations. We obtained our import registration to allow Exactech Iberica to import our products for sale in Spain and actively commenced distribution activities during the third quarter of 2010. During the first quarter of 2010, we notified our existing independent distributor in Spain of the non-renewal of our distribution agreement. As a result of that non-renewal, our relationship terminated during the third quarter of 2010. We expect a return of product from the former distributor, and as a result we have a sales return allowance of approximately \$1.3 million recorded against accounts receivable for this distributor on the consolidated balance sheet as of September 30, 2011.

License technology

Our Taiwanese subsidiary, Exactech Taiwan, has entered into a license agreement with the Industrial Technology Research Institute (ITRI) and the National Taiwan University Hospital (NTUH) for the rights to technology and patents related to the repair of cartilage lesions. As of September 30, 2011, we have paid approximately \$1.5 million for the licenses, patents, equipment related to this license agreement, and prepaid expenses, and we will make royalty payments when the technology becomes marketable. Using the technology, we plan to launch a cartilage repair program that will include a device and method for the treatment and repair of cartilage in the knee joint. It is expected that the project will require us to complete human clinical trials under the guidance of the Food & Drug Administration in order to obtain pre-market approval for the device in the United States. The agreement terms include a license fee based on the achievement of specific, regulatory milestones and a royalty arrangement based on sales once regulatory clearances are established.

Financing Activities - Financing activities provided net cash of \$7.2 million in the nine months ended September 30, 2011, as compared to \$20.6 million in net cash for the nine months ended September 30, 2010. In the first nine months of 2011, we had net borrowings under our credit line of \$7.0 million as compared to net borrowings of \$20.4 million in the first nine months of 2010. Our commercial debt facilities decreased by \$906,000 as a result of repayments during the nine months ended September 30, 2011, as compared to \$892,000 in the first nine months of 2010. Proceeds from the exercise of stock options provided cash of \$1.1 million in the nine months ended September 30, 2011, as compared to \$964,000 in the nine months ended September 30, 2010, with the proceeds used to fund general working capital needs.

Long-term Debt

On June 13, 2008, we entered into a revolving credit agreement for an aggregate principal amount of \$40 million, referred to as the Credit Agreement with SunTrust Bank, a Georgia banking corporation, or SunTrust, as administrative agent and swingline lender and potential other lenders. The credit agreement was originally composed of a revolving credit line in an amount equal to \$25 million between us and SunTrust, and a revolving credit line in an amount equal to \$15 million between us and Compass Bank, an Alabama banking corporation, or Compass. Included in the credit agreement is a swingline note for \$3 million, whereby excess bank account cash balance is swept into the swingline to reduce the outstanding balance. Interest on the notes consists of annual LIBOR, adjusted monthly, and an applicable margin, ranging from 1.25 % to 2.00%, based on a ratio of funded debt to EBITDA. The Credit Agreement has a five year term and the lending commitments under it terminate on June 13, 2013, with the swingline commitment terminating and all outstanding amounts thereunder due in full one week prior to the revolver note. The obligations under the Credit Agreement have been guaranteed by the domestic subsidiaries of the Company under the terms of a subsidiary guarantee and are secured by a security interest granted in substantially all of the assets of the Company and its domestic subsidiaries to the lenders party to the Credit Agreement. The outstanding balance under the Credit Agreement may be prepaid at any time without premiums or penalties. Upon an event of default the commitment will be terminated, all principal and interest will be payable immediately and begin to accrue interest at a default rate equal to the applicable rate in effect plus five percentage points. The Credit Agreement includes certain covenants and terms that place certain restrictions on our ability to incur additional debt, incur additional liens, engage in certain investments, effect certain mergers, declare or pay dividends, effect certain sales of assets, or engage in certain transactions with affiliates, sale and leaseback transactions, hedging agreements, or capital expenditures. Additionally, there are restrictions against us using the proceeds borrowed under this facility for funding our foreign subsidiaries unless such foreign subsidiaries are included in the facility by virtue of execution of a subsidiary guarantee or pledge of the capital stock of such foreign subsidiary. We are also subject to several financial covenants regarding the ratio of debt to EBITDA and fixed charge coverage ratio.

On November 10, 2010, we entered into an amendment to the Credit Agreement. The amendment provides us with an accordion facility that permits us to increase the revolver commitment available by an amount up to \$15 million, provided that aggregate commitments available under the Credit Agreement may not exceed \$55 million. Interest on the accordion facility accrues at an applicable margin between 2.35% and 2.50% above the LIBOR rate at the time of exercising the accordion. Additionally, the amendment amends certain terms of the Credit Agreement in respect to the calculation of the fixed charge coverage ratio as well as covenants relating to our ability to effect transactions involving our subsidiaries. We paid aggregate closing costs of \$172,000 for the Credit Agreement and amendment, which we are expensing over the life of the Credit Agreement. Additional administrative fees will be due and expensed each fiscal quarter based on a percentage of the unused revolver balance. As of September 30, 2011, there was \$44.6 million outstanding under the revolving line of credit, of which \$6.0 million bore an interest rate of 2.6%, and the remaining balance bore an interest rate of 2.0%.

In September 2002, we entered into a long-term commercial construction loan of up to \$4.2 million, bearing interest at a rate equal to one month LIBOR plus 1.5%, with a local lending institution, secured by an existing letter of credit, to fund the expansion of our corporate facility. At September 30, 2011, there was \$2.4 million outstanding under this loan bearing a variable rate of interest equal to 1.7%. In October 2005, we entered into a long-term commercial real estate loan of \$4.0 million, bearing interest at a rate of

one month LIBOR plus 1.53%, with a local lending institution to recapture costs of improvements to our existing real estate facilities and restructure portions of existing working capital debt. This variable rate debt was fixed at 6.6% interest by entering into an interest swap agreement as a cash flow hedge. At September 30, 2011, there was \$2.0 million outstanding under this loan.

Our credit facility and other loans contain customary affirmative and negative covenants including certain financial covenants with respect to our consolidated net worth, interest and debt coverage ratios and limits on capital expenditures, dividends, debt incurrence and liens in addition to other restrictions. We were in compliance with such covenants at September 30, 2011.

Other Commitments and Contingencies

At September 30, 2011, we had outstanding commitments for the purchase of inventory, raw materials and supplies of \$11.3 million and outstanding commitments for the purchase of capital equipment of \$0.7 million. Purchases under our distribution agreements were \$5.5 million during the nine months ended September 30, 2011.

As of September 30, 2011, we recorded a contingent liability of \$1.0 million based on the estimated weighted probability of the outcome of a claim by the State of Florida for sales and use tax, based on the State's audit of such tax dating back to May 2005, which was assessed by the State of Florida for the value of surgical instruments removed from inventory and capitalized as property and equipment worldwide. In consultation with counsel, management is challenging the assessment; however, there can be no assurances that we will ultimately prevail in our challenge against the assessment. In evaluating the liability, management followed the FASB guidance on contingencies, and concluded that the contingent liability is probable, based on verbal assertions by Florida Department of Revenue personnel, and can be reasonably estimated, however if we are unsuccessful in our challenge against the State of Florida, we could have a maximum potential liability of \$2.9 million for the tax period audited through September 30, 2011. Any use tax determined to be due and payable to the Florida Department of Revenue will increase the basis of the surgical instruments, and this amount will be amortized over the remaining useful life of the instruments.

CAUTIONARY STATEMENT RELATING TO FORWARD LOOKING STATEMENTS

This report contains various “forward looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which represent the Company’s expectations or beliefs concerning future events, including, but not limited to, statements regarding growth in sales of the Company’s products, profit margins and the sufficiency of the Company’s cash flow for its future liquidity and capital resource needs. When used in this report, the terms “anticipate,” “believe,” “estimate,” “expect” and “intend” and words or phrases of similar import, as they relate to the Company or its subsidiaries or its management, are intended to identify forward-looking statements. These forward-looking statements are further qualified by important factors that could cause actual results to differ materially from those in the forward-looking statements. These factors include, without limitation, the impact of our DPA monitorship, including the associated compliance costs, the outcome of the State of Florida unasserted claim, the effect of competitive pricing, the Company’s dependence on the ability of its third-party suppliers to produce components on a cost-effective basis to the Company, significant expenditures of resources to maintain high levels of inventory, market acceptance of the Company’s products, the outcome of litigation, the effects of governmental regulation, potential product liability risks and risks of securing adequate levels of product liability insurance coverage, and the availability of reimbursement to patients from health care payers for procedures in which the Company’s products are used. Results actually achieved may differ materially from expected results included in these statements as a result of these or other factors, including those factors discussed under “Risk Factors” in our 2010 annual report on Form 10-K and each quarterly report on Form 10-Q we have filed after this annual report. Exactech undertakes no obligation to update, and the Company does not have a policy of updating or revising, these forward-looking statements. Except where the context otherwise requires, the terms, “we”, “us”, “our”, “the Company,” or “Exactech” refer to the business of Exactech, Inc. and its consolidated subsidiaries.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk from interest rates. For our cash and cash equivalents, a change in interest rates affects the amount of interest income that can be earned. For our debt instruments, changes in interest rates affect the amount of interest expense incurred.

The table that follows provides information about our financial instruments that are sensitive to changes in interest rates. If our variable rates of interest experienced an upward increase of 1%, our debt service would increase approximately \$3,000 for the remainder of 2011. We believe that the amounts presented approximate the financial instruments' fair market value as of September 30, 2011, and the weighted average interest rates are those experienced during the year to date ended September 30, 2011 (in thousands, except percentages):

| | 2011 | 2012 | 2013 | 2014 | Thereafter | Total |
|--|-------|--------|--------|--------|------------|----------|
| Liabilities | | | | | | |
| Commercial construction loan at variable interest rate | \$ 53 | \$ 210 | \$ 210 | \$ 210 | 1,675 | \$ 2,358 |
| Weighted average interest rate | 1.7 % | | | | | |
| Commercial real estate loan at fixed rate swap | 105 | 441 | 471 | 503 | 435 | 1,955 |
| Weighted average interest rate | 6.6 % | | | | | |
| Line of credit at variable interest rate | — | — | 44,591 | — | — | 44,591 |
| Weighted average interest rate | 1.9 % | | | | | |

We are exposed to market risk related to changes in foreign currency exchange rates. The functional currency of substantially all of our international subsidiaries is the local currency. Transactions are translated into U.S. dollars and exchange gains and losses arising from translation are recognized in "Other comprehensive income (loss)". Fluctuations in exchange rates affect our financial position and results of operations. The majority of our foreign currency exposure is to the Euro (EUR), Pound Sterling (GBP), and Japanese Yen (JPY). During the nine months ended September 30, 2011, translation losses were \$13,000, which were primarily due to the fluctuation in exchange rates and the strengthening of the EUR and GBP in the first nine months of 2011. During the nine months ended September 30, 2010, translation losses were \$366,000 which were due to the weakening of the EUR.

In connection with some agreements, we are subject to risk associated with international currency exchange rates on purchases of inventory payable in Euros. At present, we do not hedge our exposure or invest in international currency derivatives. The U.S. dollar is considered our primary currency, and transactions that are completed in an international currency are translated into U.S. dollars and recorded in the financial statements. We recognized currency transaction gains of \$845,000 for the nine months ended September 30, 2011 and currency transaction gains of \$669,000 for the nine months ended September 30, 2010, primarily due to the effect of our European expansion and the strengthening of the Euro as compared to the U.S. dollar during the first half of 2011. We do not believe we are currently exposed to any material risk of loss due to exchange rate risk exposure.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer ("CEO") and our Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of our disclosure controls and procedures, or "disclosure controls," pursuant to Exchange Act Rule 13a-15(b). Disclosure controls are controls and procedures designed to reasonably ensure that information required to be disclosed in our reports filed under the Exchange Act, such as this quarterly report, is recorded, processed, summarized and reported within the time periods specified in the U.S. Securities and Exchange Commission's rules and forms. Disclosure controls include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to our management, including our CEO and CFO, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. Our disclosure controls include some, but not all, components of our internal control over financial reporting. Based upon that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of September 30, 2011.

Change in Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting during the quarter ended September 30, 2011, 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

There have been no material developments related to our legal proceedings since the filing of our most recent Annual Report on Form 10-K, as updated by our subsequently filed Quarterly Reports on Form 10-Q.

Item 1A. Risk Factors

Information about risk factors for the nine months ended September 30, 2011, does not differ materially from those in set forth in Part I, Item 1A, of our Annual Report on Form 10-K for the year ended December 31, 2010.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

Item 5. Other Information

None

Item 6. Exhibits

(a) Exhibits

- 10.1 Third amendment to employment agreement between Exactech, Inc. and R. William Petty, M.D.(1)
- 10.2 Amendment to Exactech, Inc. 2009 Executive Incentive Compensation Plan (2)
- 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer pursuant to 18 USC Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 USC Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS** XBRL Instance Document
- 101.SCH** XBRL Taxonomy Extension Schema
- 101.CAL** XBRL Taxonomy Extension Calculation Linkbase
- 101.DEF** XBRL Taxonomy Extension Definition Linkbase
- 101.LAB** XBRL Taxonomy Extension Label Linkbase
- 101.PRE** XBRL Taxonomy Extension Presentation Linkbase

(1) Incorporated by reference to exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the SEC on October 6, 2011.

(2) Incorporated by reference to exhibit A to the Company's Definitive Proxy Statement on Schedule 14A, filed with the SEC on April 29, 2011.

** Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability.

SIGNATURES

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

Exactech, Inc.

Date: November 8, 2011

By: /s/ William Petty
William Petty, M.D.
Chief Executive Officer (principal executive officer), President and Chairman of the Board

Date: November 8, 2011

By: /s/ Joel C. Phillips
Joel C. Phillips
Chief Financial Officer (principal financial officer and principal accounting officer) and Treasurer

CERTIFICATION

I, William Petty, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Exactech, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared; and
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of the internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: November 8, 2011

/s/ William Petty
William Petty, M.D.
Chief Executive Officer, President
and Chairman of the Board

CERTIFICATION

I, Joel C. Phillips, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Exactech, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared; and
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of the internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: November 8, 2011

/s/ Joel C. Phillips

Joel C. Phillips
Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Exactech, Inc. (the "Company") for the period ended September 30, 2011 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, William Petty, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly present, in all material respects, the financial condition and results of operations of the Company.

/s/ William Petty
William Petty, M.D.
Chief Executive Officer
November 8, 2011

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Exactech, Inc. (the "Company") for the period ended September 30, 2011 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Joel C. Phillips, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly present, in all material respects, the financial condition and results of operations of the Company.

/s/ Joel C. Phillips

Joel C. Phillips
Chief Financial Officer
November 8, 2011