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

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**FORM 10-Q**

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(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, 2007

**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

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**EXACTECH, INC.**

(Exact name of registrant as specified in its charter)

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**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)

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

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.

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Class	Outstanding at November 6, 2007
Common Stock, \$.01 par value	11,596,001

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EXACTECH, INC.

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## Item 1. Financial Statements

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

	(unaudited) September 30, <u>2007</u>	(audited) December 31, <u>2006</u>
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 805	\$ 2,006
Accounts receivable, net of allowances of \$816 and \$572	21,448	17,524
Prepaid expenses and other assets, net	1,338	1,325
Income taxes receivable	—	219
Inventories – current	47,684	38,742
Deferred tax assets	470	271
Total current assets	<u>71,745</u>	<u>60,087</u>
PROPERTY AND EQUIPMENT:		
Land	1,139	1,015
Machinery and equipment	15,919	14,851
Surgical instruments	30,548	26,189
Furniture and fixtures	2,250	2,078
Facilities	11,196	10,481
Projects in process	1,710	—
Total property and equipment	<u>62,762</u>	<u>54,614</u>
Accumulated depreciation	<u>(26,588)</u>	<u>(22,386)</u>
Net property and equipment	36,174	32,228
OTHER ASSETS:		
Notes receivable – related party	4,394	2,904
Other investments	123	398
Deferred financing and deposits, net	814	694
Non-current inventory	2,132	11,679
Product licenses and designs, net	1,453	994
Patents and trademarks, net	2,247	3,938
Goodwill	352	352
Total other assets	<u>11,515</u>	<u>20,959</u>
<b>TOTAL ASSETS</b>	<u>\$ 119,434</u>	<u>\$ 113,274</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
CURRENT LIABILITIES:		
Accounts payable	\$ 10,854	\$ 5,621
Income taxes payable	264	113
Accrued expenses and other liabilities	5,742	4,573
Line of credit	5,088	—
Current portion of long-term debt	1,641	1,633
Total current liabilities	<u>23,589</u>	<u>11,940</u>
LONG-TERM LIABILITIES:		
Deferred tax liabilities	2,338	2,620
Line of credit	—	11,116
Long-term debt, net of current portion	9,589	10,668
Other long-term liabilities	37	7
Total long-term liabilities	<u>11,964</u>	<u>24,411</u>
Total liabilities	35,553	36,351
SHAREHOLDERS' EQUITY:		
Common stock	116	115
Additional paid-in capital	26,293	25,105
Accumulated other comprehensive loss	(14)	(5)
Retained earnings	57,486	51,708
Total shareholders' equity	<u>83,881</u>	<u>76,923</u>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<u>\$ 119,434</u>	<u>\$ 113,274</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,	
	2007	2006	2007	2006
NET SALES	\$ 29,985	\$ 24,286	\$ 91,140	\$ 76,262
COST OF GOODS SOLD	10,056	8,507	32,677	27,444
Gross profit	19,929	15,779	58,463	48,818
OPERATING EXPENSES:				
Sales and marketing	9,826	7,059	28,241	22,130
General and administrative	2,405	2,411	8,311	7,276
Research and development	2,037	1,423	5,747	4,627
Impairment loss	—	—	1,519	—
Depreciation and amortization	1,476	1,378	4,491	4,210
Total operating expenses	15,744	12,271	48,309	38,243
INCOME FROM OPERATIONS	4,185	3,508	10,154	10,575
OTHER INCOME (EXPENSE):				
Interest income	98	81	252	176
Interest expense	(330)	(652)	(1,097)	(1,729)
Foreign currency exchange loss	(4)	(49)	(52)	(95)
Total other expenses	(236)	(620)	(897)	(1,648)
INCOME BEFORE INCOME TAXES	3,949	2,888	9,257	8,927
PROVISION FOR INCOME TAXES	1,351	991	3,187	3,258
INCOME BEFORE EQUITY IN NET LOSS OF OTHER INVESTMENTS	2,598	1,897	6,070	5,669
EQUITY IN NET LOSS OF OTHER INVESTMENTS	(113)	(53)	(292)	(167)
NET INCOME	<u>\$ 2,485</u>	<u>\$ 1,844</u>	<u>\$ 5,778</u>	<u>\$ 5,502</u>
 BASIC EARNINGS PER SHARE	 <u>\$ 0.22</u>	 <u>\$ 0.16</u>	 <u>\$ 0.50</u>	 <u>\$ 0.48</u>
 DILUTED EARNINGS PER SHARE	 <u>\$ 0.21</u>	 <u>\$ 0.16</u>	 <u>\$ 0.49</u>	 <u>\$ 0.47</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, 2006	11,518	\$ 115	\$ 25,105	\$ 51,708	\$ (5)	\$ 76,923
Exercise of stock options	48	1	512	—	—	513
Issuance of restricted common stock for services	3	—	52	—	—	52
Issuance of common stock under the Employee Stock Purchase Plan	22	—	184	—	—	184
Compensation cost of stock options	—	—	376	—	—	376
Tax benefit from exercise of stock awards	—	—	64	—	—	64
Comprehensive income:						
Net income	—	—	—	5,778	—	5,778
Change in fair value of cash flow hedge, net of tax	—	—	—	—	(9)	(9)
Other comprehensive loss						(9)
Comprehensive income						5,769
Balance, September 30, 2007	<u>11,591</u>	<u>\$ 116</u>	<u>\$ 26,293</u>	<u>\$ 57,486</u>	<u>\$ (14)</u>	<u>\$ 83,881</u>

See notes to condensed consolidated financial statements

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

	<b>Nine Month Periods Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 5,778	\$ 5,502
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for allowance for doubtful accounts and sales returns	245	61
Inventory impairment	633	473
Depreciation and amortization	5,035	4,660
Restricted common stock issued for services	52	—
Compensation cost of stock awards	376	169
Tax benefit from exercise of stock options	64	257
Excess tax benefit from exercise of stock options	(36)	(170)
Loss on disposal of equipment	32	86
Loss on impairment	1,519	—
Foreign currency exchange loss	52	95
Equity in net loss of other investments	292	167
Deferred income taxes	(481)	(249)
Changes in assets and liabilities which provided (used) cash:		
Accounts receivable	(4,169)	(1,803)
Prepays and other assets	(73)	130
Inventories	(28)	754
Accounts payable	5,107	(3,810)
Income taxes payable/receivable	370	233
Accrued expense & other liabilities	1,190	454
Net cash provided by operating activities	15,958	7,009
<b>INVESTING ACTIVITIES:</b>		
Notes receivable issued to related party	(1,490)	(852)
Purchases of property and equipment	(8,619)	(4,368)
Purchases of product licenses and designs	(600)	—
Cost of patents and trademarks	—	(168)
Net cash used in investing activities	(10,709)	(5,388)
<b>FINANCING ACTIVITIES:</b>		
Net repayments on line of credit	(6,028)	(3,418)
Principal payments on debt	(1,071)	(606)
Proceeds from long-term debt	—	1,189
Debt issuance costs	(84)	(93)
Excess tax benefit from exercise of stock options	36	170
Proceeds from issuance of common stock	697	901
Net cash used in financing activities	(6,450)	(1,857)
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	(1,201)	(236)
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	2,006	1,007
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	\$ 805	\$ 771
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>		
Cash paid during the period for:		
Interest	\$ 1,020	\$ 552
Income taxes	3,180	3,089
Non-cash investing and financing activities:		
Cash flow hedge (loss) gain	\$ (9)	\$ 26
Financing of insurance premiums	—	199

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, 2007 AND 2006**  
**(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, 2006 of Exactech, Inc. (the "Company" or "Exactech"), as filed with the Securities and Exchange Commission.

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. The Company's subsidiaries, Exactech Asia and Exactech UK, are consolidated for financial reporting purposes, and all intercompany balances and transactions have been eliminated. Results of operations for the three and nine month periods ended September 30, 2007, 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.

A significant item reclassified for the three and nine month periods ended September 30, 2006, was the expense incurred for payment of royalties, which has been reclassified from operating expense to cost of goods sold. These royalty expenses represent payments made to the owners of patents and contributing surgeons who have licensed the use of their inventions or contributed their professional expertise to Exactech for our product development and manufacturing uses. Royalty expense was \$691,000 for the three months ended September 30, 2006 and \$2,373,000 for the nine months ended September 30, 2006.

**2. NEW ACCOUNTING PRONOUNCEMENTS**

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") 157, "Fair Value Measurements." This standard defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States ("GAAP"), and expands disclosures about fair value measurements. This standard is effective for financial statements issued for fiscal years beginning after November 15, 2007. Exactech is currently evaluating the requirements of SFAS 157 and has not yet determined the impact on the Company's financial condition, results of operations or cash flows.

In February 2007, the FASB issued SFAS 159, "Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115". SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The statement is effective for fiscal years beginning after November 15, 2007. Exactech is currently evaluating the requirements of SFAS 159 and has not yet determined the impact on the Company's financial condition, results of operations or cash flows.

**3. INTANGIBLE ASSET IMPAIRMENT**

As a part of our comprehensive hard bearing program, we entered into a license and distribution agreement with Dimicron Corporation in 2003 to market and distribute polycrystalline diamond compact hip bearings. During the second quarter of 2007, we engaged in discussions with Dimicron regarding the fact that, while Dimicron has made progress in developing the technology, they had encountered new

challenges that they believe will adversely impact their ability to produce the diamond hip bearings they had been developing. Based on previous and anticipated delays, uncertainty regarding production of a product, disagreement with Dimicron about how best to proceed, and our anticipating no future cash flows, we determined we were required to take a non-cash impairment charge to fully impair the license to the patent we hold with Dimicron. The impairment charge taken in the second quarter of 2007, for the current full carrying value of the asset, was \$1.5 million before income taxes, and is included as an operating expense in our condensed consolidated statement of income.

#### 4. 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. 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 Exactech. Impairment 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 impairment charge to reduce the carrying value of any impaired inventory to its estimated fair value, which becomes its new cost basis. Impairment charges for the three and nine months ended September 30, 2007, were \$111,000 and \$633,000, respectively. Impairment charges for the three and nine months ended September 30, 2006 were \$127,000 and \$473,000, respectively. Inventory is also reviewed for the ability to turn over the inventory within the next twelve months, and inventory, in total, that is not projected to be sold during the following twelve month period is classified as a non-current asset on the condensed consolidated balance sheets. As of September 30, 2007 and December 31, 2006, we had \$2,132,000 and \$11,679,000 of inventory recorded as a non-current asset, respectively.

The following table summarizes the Company's classifications of inventory as of September 30, 2007 and December 31, 2006 (in thousands):

	September, 30 2007	December 31, 2006
Raw materials	\$ 12,008	\$ 14,227
Work in process	782	500
Finished goods on hand	18,190	18,748
Finished goods on loan	18,836	16,946
Inventory total	49,816	50,421
Non-current inventory	2,132	11,679
Inventory – current	\$ 47,684	\$ 38,742

#### 5. INCOME TAX

Exactech adopted the provisions of FASB Interpretation 48, "Accounting for Uncertain Tax Positions, an Interpretation of SFAS No. 109" ("FIN 48"), on January 1, 2007. The interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Exactech's adoption of FIN 48 did not have a material impact on our financial condition, results of operations, or cash flows, as management

determined that we did not have any uncertain tax positions requiring recognition as a result of the adoption of FIN 48. Our policy is to recognize interest and penalties accrued on uncertain tax positions as part of income tax expense. For the nine months ended September 30, 2007, no estimated interest or penalties were recognized for the uncertainty of certain tax positions. We file income tax returns in the United States, various states, and foreign jurisdictions. Tax years 2004 and forward remain open to examination under United States statutes of limitation.

## 6. DEBT

Debt consists of the following at September 30, 2007 and December 31, 2006 (in thousands):

	<u>2007</u>	<u>2006</u>
Industrial Revenue Bond payable in annual principal installments as follows: \$200 per year from 2007-2014; \$100 per year from 2015-2017; monthly interest payments based on adjustable rate as determined by the bonds remarketing agent based on market rate fluctuations (3.92% as of September 30, 2007); proceeds used to finance construction of current facility	\$ 1,800	\$ 1,800
Commercial construction loan payable in monthly principal installments of \$17.5, plus interest based on adjustable rate as determined by one month LIBOR (6.64% as of September 30, 2007); proceeds used to finance expansion of current facility	3,198	3,363
Commercial equipment loan payable in monthly principal installments of \$25.4, beginning April 2004, plus interest based on adjustable rate as determined by one month LIBOR with a minimum floor of 3.5% (6.89% as of September 30, 2007); proceeds used to finance equipment for facility expansion	432	662
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% (6.89% as of September 30, 2007); proceeds used to finance equipment for production facility expansion	2,377	2,823
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.	3,423	3,653
Business line of credit payable on a revolving basis, plus interest based on adjustable rate as determined by one month LIBOR based on the Company's ratio of funded debt to EBITDA (6.87% as of September 30, 2007). Proceeds used to fund inventory purchases.	5,088	11,116
Total debt	16,318	23,417
Less current portion	(6,729)	(1,633)
	<u>\$ 9,589</u>	<u>\$ 21,784</u>

The following is a schedule of debt maturities as of September 30, 2007, for the years ended December 31:

2007	.....	\$	562
2008	.....		6,734
2009	.....		1,415
2010	.....		1,390
2011	.....		1,270
Thereafter	.....		4,947
		\$	<u>16,318</u>

## 7. COMMITMENTS AND CONTINGENCIES

### Litigation

There are various claims, lawsuits, and disputes with third parties and pending actions involving various allegations against the Company incident to the operation of the business, principally product liability cases. We recently settled a product liability suit filed in Madrid, Spain, for \$13,000, which was paid during the third quarter of 2007. We are currently a party to several products liability suits related to the products distributed by Exactech on behalf of Regeneration Technologies, Inc. ("RTI"). Pursuant to our license and distribution agreement with RTI, we will tender all cases to RTI. While we believe that these cases are without merit, we are unable to predict the outcome of this or other such litigation. Therefore, we maintain product liability insurance, subject to self-insured retention limits, for these and all such claims, and establish accruals for product liability and other claims, based upon our experience with past claims, advice of counsel, and the best information available. At September 30, 2007, our accrual for product liability claims decreased \$220,000 from December 31, 2006, primarily as a result of the resolution of the case in Madrid, Spain and resolution of certain other claims. Certain matters are subject to various uncertainties, and it is possible that those matters may be resolved unfavorably to us. However, while it is not possible to predict with certainty the outcome of these types of claims, it is the opinion of management that, upon ultimate resolution, these matters 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.

### Purchase Commitments

At September 30, 2007, Exactech had outstanding commitments for the purchase of inventory, raw materials and supplies of \$11.2 million and outstanding commitments for the purchase of capital equipment of \$666,000. We maintain several distribution agreements with third parties, of which we had \$7.8 million in purchases during the nine months ended September 30, 2007. During October 2007, we agreed with Waldemar Link to terminate our distribution of Link<sup>®</sup> hip, knee, and ankle products and assist in the transition of distribution of the Link products after the expiration of the agreement on December 31, 2007. Pursuant to this agreement, Waldemar Link will repurchase any inventory, including surgical instrumentation that remains as of December 31, 2007, which is currently estimated to be approximately \$7.8 million.

### Financing Commitments

Exactech has committed to make loans available to Altiva Corporation, a company in which we hold a minority interest in an amount of up to \$5 million for a period of five years, the proceeds of which shall be used for the acquisition of various spine and spine-related product lines. Funding obligations under this commitment are upon the request of Altiva's management and board of directors and are subject to Exactech's reasonable discretion to approve the product line or technology acquisition(s) by Altiva to be

funded by the requested loan(s). As of September 30, 2007, Exactech had extended to Altiva the principal sum of \$4.4 million under this commitment, bearing interest currently at 8.9%. These loans are due in four equal annual installments beginning November 1, 2009 through November 1, 2012. These loans can be converted into shares of Series C Preferred stock of Altiva, at Exactech's option, any time between October 29, 2005 and October 28, 2008, and in the event that Exactech loans the full \$5 million commitment, upon conversion of all outstanding balances under the loans, Exactech will own a 54.5% interest in Altiva. In addition, Exactech has committed to provide Altiva with, or guarantee on behalf of Altiva, a working capital credit line in an amount up to \$6 million, which is collateralized by substantially all of Altiva's assets, subject to the prior liens of the lender that provides the working capital line to Altiva. Pursuant to this commitment, Exactech has guaranteed a \$6 million line of credit with Merrill Lynch. This guarantee is limited to a principal amount not to exceed \$6 million and a term not to exceed October 30, 2008. As of September 30, 2007, there was \$6.0 million borrowed under this line. Based upon the expected present values of probability weighted future cash flows of Altiva pursuant to requirements in FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees Including Indirect Guarantees of Indebtedness of Others", the Company has recorded a liability of \$252,000 related to its guarantee of Altiva's debt with Merrill Lynch pursuant to this commitment. Each interim period, Exactech evaluates its investment in Altiva pursuant to FASB Interpretation No. 46, "Consolidation of Variable Interest Entities", as revised ("FIN 46R") to determine if the fair value of the equity investment, guarantee of a line of credit and commitment to fund convertible debt constitutes more than 50% of the fair value of Altiva's total equity, subordinated debt and other forms of subordinated financial support. We may be required to consolidate Altiva assuming that we continue the funding of product line acquisitions. Exactech has evaluated its investment in Altiva Corporation at September 30, 2007 in accordance with the provisions of FIN 46R, and based upon this analysis, has determined that Altiva does not qualify as a variable interest entity requiring consolidation.

Exactech, Altiva, all other holders of Altiva's preferred stock and certain officers of Altiva have also entered into a stockholders agreement under the terms of which Exactech was granted an option, exercisable any time between October 29, 2005 and October 28, 2008, to purchase all of the outstanding shares of Altiva's common stock, preferred stock and securities that are convertible into common stock or preferred stock, or all or substantially all of the assets of Altiva. The purchase price payable under this buyout option will be equal to 80% of the valuation of Altiva's business, which valuation is subject to a floor of \$25.0 million and adjustments for the amounts of indebtedness, cash and cash equivalents and accounts payable Altiva holds at the time the purchase price is calculated. The stockholders agreement provides that the Altiva valuation will be calculated by applying a buyout multiple to Altiva's trailing twelve months revenue as of the date the purchase price is calculated. This buyout multiple is calculated by reference to an "Exactech Multiple" which is calculated by dividing Exactech's average stock price for the preceding 90 days by Exactech's trailing twelve months revenue per share. Under the formulations set forth in the stockholders agreement with respect to the relationship between the buyout multiple and the Exactech Multiple, the buyout multiples would range from 1.5 to 4.0 based on the Exactech Multiple at that time.

## **8. SEGMENT INFORMATION**

We evaluate our operating segments by our major product lines: knee, hip, biologics, upper extremity and other products. The "other" segment includes miscellaneous sales categories, such as surgical instruments held for sale, bone cement, instrument rental fees, shipping charges, and other implant product lines. We previously included our upper extremity product line in the "other" segment, however, due to the growth in the upper extremity segment we have separated this segment and reclassified segment amounts for prior periods. 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 Exactech's consolidated financial statements included in our annual report on Form 10-K for the year ended December 31, 2006.

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, goodwill 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, 2007, was \$6.0 million. Included in these assets is \$4.7 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)	Knee	Hip	Biologics	Upper Extremity	Other	Corporate	Total
<b>Three months ended September 30,</b>							
<b>2007</b>							
Net sales	\$ 14,325	\$ 5,997	\$ 4,228	\$ 2,434	\$ 3,001	\$ —	\$ 29,985
Segment profit (loss)	2,810	658	125	706	(114)	(236)	3,949
Total assets, net	32,594	22,943	4,862	4,474	7,719	46,842	119,434
Capital expenditures	573	668	22	332	309	1,561	3,465
Depreciation and Amortization	626	380	50	93	86	433	1,668
<b>2006</b>							
Net sales	\$ 12,030	\$ 4,533	\$ 3,373	\$ 1,130	\$ 3,220	\$ —	\$ 24,286
Segment profit (loss)	2,762	515	204	326	(299)	(620)	2,888 <sup>(2)</sup>
Total assets, net	35,758	28,316	3,129	3,600	3,550	41,049	115,402 <sup>(3)</sup>
Capital expenditures	1,851	37	—	132	94	283	2,397
Depreciation and Amortization	603	414	58	75	70	304	1,524 <sup>(4)</sup>
<b>Nine months ended September 30,</b>							
<b>2007</b>							
Net sales	\$ 46,919	\$ 16,917	\$ 11,634	\$ 6,356	\$ 9,314	\$ —	\$ 91,140
Segment profit (loss)	7,933	435 <sup>(1)</sup>	538	1,811	(563)	(897)	9,257
Total assets, net	32,594	22,943	4,862	4,474	7,719	46,842	119,434
Capital expenditures	2,373	1,483	353	623	572	3,815	9,219
Depreciation and Amortization	1,917	1,159	132	260	241	1,326	5,035
<b>2006</b>							
Net sales	\$ 40,311	\$ 12,942	\$ 9,679	\$ 3,533	\$ 9,797	\$ —	\$ 76,262
Segment profit (loss)	8,575	1,686	508	986	(1,180)	(1,648)	8,927 <sup>(2)</sup>
Total assets, net	35,758	28,316	3,129	3,600	3,550	41,049	115,402 <sup>(3)</sup>
Capital expenditures	2,843	301	36	201	307	965	4,653
Depreciation and Amortization	1,837	1,253	171	235	204	960	4,660 <sup>(4)</sup>

<sup>(1)</sup> The segment profit (loss) for the nine month period ended September 30, 2007, for the hip segment includes an asset impairment loss for \$1,519,000. See Note 3 for further discussion on the impairment.

<sup>(2)</sup> The segment profit (loss) for the three and nine month periods ended September 30, 2006, was adjusted to reflect our income before income taxes. The adjustments of \$620,000 and \$1,648,000 were related to interest and other expense and are not allocated to individual segments.

<sup>(3)</sup> The total assets as of September 30, 2006, were adjusted to reflect the deferred tax asset change from current to non-current, related to our reclassification of current inventory to non-current inventory in 2006.

<sup>(4)</sup> Depreciation and amortization for the three and nine month period ended September 30, 2006, were adjusted to include depreciation expense included in our cost of goods sold.

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

<b>Three months ended September 30,</b>	<b>2007</b>	<b>2006</b>
Domestic sales	\$ 24,616	\$ 19,853
International sales	5,369	4,433
Total sales	<u>\$ 29,985</u>	<u>\$ 24,286</u>

  

<b>Nine months ended September 30,</b>	<b>2007</b>	<b>2006</b>
Domestic sales	\$ 70,590	\$ 59,643
International sales	20,637	16,619
Total sales	<u>\$ 91,140</u>	<u>\$ 76,262</u>

## 9. 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):

	<b>Income Shares (Numer- (Denom- ator) inator) Per Share</b>			<b>Income Shares (Numer- (Denom- ator) inator) Per Share</b>		
	<b>Three Months Ended September 30, 2007</b>			<b>Three Months Ended September 30, 2006</b>		
Net income	\$ 2,485			\$ 1,844		
<b>Basic EPS:</b>						
Net income available to common shareholders	\$ 2,485	11,544	<u>\$ 0.22</u>	\$ 1,844	11,487	<u>\$ 0.16</u>
Effect of dilutive securities:						
Stock options		<u>244</u>			<u>201</u>	
<b>Diluted EPS:</b>						
Net income available to common shareholders plus assumed conversions	\$ 2,485	11,788	<u>\$ 0.21</u>	\$ 1,844	11,688	<u>\$ 0.16</u>

  

	<b>Income Shares (Numer- (Denom- ator) inator) Per Share</b>			<b>Income Shares (Numer- (Denom- ator) inator) Per Share</b>		
	<b>Nine Months Ended September 30, 2007</b>			<b>Nine Months Ended September 30, 2006</b>		
Net income	\$ 5,778			\$ 5,502		
<b>Basic EPS:</b>						
Net income available to common shareholders	\$ 5,778	11,559	<u>\$ 0.50</u>	\$ 5,502	11,441	<u>\$ 0.48</u>
Effect of dilutive securities:						
Stock options		<u>249</u>			<u>213</u>	
<b>Diluted EPS:</b>						
Net income available to common shareholders plus assumed conversions	\$ 5,778	11,808	<u>\$ 0.49</u>	\$ 5,502	11,654	<u>\$ 0.47</u>

For the three months ended September 30, 2007, weighted average options to purchase 309,570 shares of common stock at exercise prices ranging from \$12.53 to \$21.09 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, 2006, weighted average options to purchase 458,000 shares of common stock at exercise prices ranging from \$12.53 to \$21.09 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, 2007, weighted average options to purchase 302,997 shares of common stock at exercise prices ranging from \$12.53 to \$21.09 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, 2006, weighted average options to purchase 479,000 shares of common stock at exercise prices ranging from \$12.53 to \$21.09 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:**

Exactech sponsors an Executive Incentive Compensation Plan ("2003 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. The 2003 Plan is a comprehensive, consolidated incentive compensation plan that replaced all of the Company's pre-existing stock plans. The 2003 Plan was implemented upon shareholder approval at its Annual Meeting of Shareholders on May 2, 2003. Common stock issued upon exercise of stock options is settled with authorized but unissued shares available. The maximum number of common shares issuable under the 2003 Plan is 3,000,000 shares. Under the plan, the exercise price of option awards equals the market price of the Company's stock on the date of grant, and has a maximum term of ten years. As of September 30, 2007, there were 589,256 total remaining shares issuable under the 2003 Plan.

We apply the fair-value method under SFAS 123R in accounting for employee options, as well as shares issued under our Employee Stock Purchase Plan ("ESPP"). The fair value of each option granted to employees and each ESPP award is estimated on the date of grant using the Black-Scholes-Merton option-pricing model with weighted-average assumptions used for grants on the date of grant. We apply Emerging Issues Task Force Consensus ("EITF") 96-18 to stock-based compensation granted to non-employees. EITF 96-18 requires the fair value of stock awards to be remeasured until a measurement date is achieved.

The compensation cost that has been charged against income for the 2003 Plan and ESPP was \$376,000 and \$169,000 and income tax benefit of \$64,000 and \$257,000 for the nine months ended September 30, 2007 and 2006, respectively. Included in the above compensation cost is non-employee stock compensation expense of approximately \$44,000 and \$55,000, net of taxes, during the nine months ended September 30, 2007 and 2006, respectively. As of September 30, 2007, total unrecognized compensation cost related to unvested awards was \$550,000 and is expected to be recognized over a weighted-average period of 2.08 years.

## Stock Options:

A summary of the status of stock option activity under our stock-based compensation plans as of September 30, 2007 and changes during the nine months is presented below:

Options	2007			Aggregate Intrinsic Value (In thousands)
	Shares	Weighted Avg Exercise Price	Weighted Remaining Contractual Term	
Outstanding – January 1	1,025,380	\$ 12.30		
Granted	20,000	15.62		–
Exercised	(47,816)	8.95		317
Forfeited or Expired	(8,434)	15.13		
Outstanding – September 30	<u>989,130</u>	<u>\$ 12.50</u>	<u>5.53</u>	<u>\$ 3,966</u>
Exercisable – September 30	<u>834,282</u>	<u>\$ 12.15</u>	<u>5.04</u>	<u>\$ 3,691</u>

Weighted average fair value per share of  
options vested during the period

	<u>\$ 9.71</u>
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Weighted average fair value per share of  
options granted during the period

	<u>\$ 8.70</u>
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Outstanding options, consisting primarily of ten-year incentive stock options, vest and become exercisable ratably over a five-year period from the date of grant. The outstanding options expire ten years from the date of grant or upon retirement from Exactech, and are contingent upon continued employment during the applicable ten-year period. 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 5,000 stock options granted to our newly elected non-employee director upon election to the board of directors in May 2007. There were 15,000 of employee stock options granted in August 2007. No stock options were granted during the nine months ended September 30, 2006.

## Restricted Stock Awards:

Under the 2003 Plan, Exactech 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 December 2006, the Committee approved equity compensation to the four 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 options for the purchase of 5,000 shares of common stock, or a restricted stock award of 1,675 shares of common stock, the choice being at the discretion of each individual director. Pursuant to the approved grant, three of our outside directors chose to receive the restricted stock awards.

The restricted stock awards were divided and issuable in three equal awards with grant dates of December 20, 2006, January 15, 2007, and April 15, 2007. These restricted stock awards were considered fully vested at each of the grant dates, and the fair value at the date of grant was recognized as an operating expense in the consolidated statements of income. The restricted stock awards are restricted from trading for five years from the earliest award date. There was no service period and thus, no risk or provision for forfeiture.

On December 20, 2006, we issued the first award of 1,674 shares of our common stock to the members of our board of directors that selected the restricted stock awards, and recognized the grant date fair value for the grants of \$24,000. The second award of an aggregate of 1,674 shares of common stock

was issued January 15, 2007, with a grant date fair value of \$24,000. The final award of 1,677 was issued in April 2007, with a grant date fair value of \$28,000. We did not grant any restricted stock awards prior to the grant in December 2006.

**Employee Stock Purchase Plan:**

Under the 1999 Employee Stock Purchase Plan, employees are allowed to purchase shares of the Company's common stock at a fifteen percent (15%) discount via payroll deduction. There are 250,000 shares reserved for issuance under the plan. Employees participating in this plan purchased approximately 22,000 and 20,000 shares in each of the nine months ended September 30, 2007 and 2006. The fair value of the employee's purchase rights is estimated using the Black-Scholes-Merton option-pricing model with the following assumptions for 2007 and 2006, respectively: dividend yield of zero for all years; an expected life of 1 year for all years; expected volatility of 31 and 36 percent; and risk-free interest rates of 5.1 and 4.5 percent. The weighted-average fair value of those purchase shares granted in 2007 and 2006 was \$3.31 and \$2.91, respectively. There are 65,905 shares remaining available to purchase under the plan at September 30, 2007.

## **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 herein.

### **Overview of the Company**

Exactech develops, manufactures, markets and sells orthopaedic implant devices, related surgical instrumentation, supplies and biologic materials to hospitals and physicians in the United States and internationally. Exactech's revenues are primarily derived from sales of its knee and hip joint replacement systems; however, revenues from worldwide distribution of biologic materials and other product lines has increased as a percentage of the Company's total revenues over the past several years, as Exactech expands its current distribution from the ongoing introduction of new, advanced biologic materials and other products and services. Revenue from sales of other products, including surgical instrumentation, Cemex<sup>®</sup> bone cement, the InterSpace<sup>™</sup> pre-formed, antibiotic cement hip, knee and shoulder spacers, and the Equinoxe<sup>®</sup> shoulder systems have contributed to Exactech's revenue growth and are expected to continue to be an important part of the Company's anticipated future revenue growth.

In marketing its products, Exactech uses a combination of traditional targeted media marketing and direct customer contact and service to orthopaedic surgeons, which is our primary marketing focus. Since 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 developing relationships and meeting the needs of the surgeon community in the orthopaedic industry. In cooperation with our organization of independent sales agencies in the United States and network of independent distributors and subsidiaries internationally, Exactech conducts this effort through continuing education forums, training programs and product development advisory panels.

Exactech's 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 surgeons on the Company's behalf. As a result of the nature of these sales and marketing expenses, 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, shoulder and hip implant product lines and biologic materials and services.

### **Overview of the Three and Nine Months Ended September 30, 2007**

During the three months ended September 30, 2007, sales increased 23% to \$30.0 million from \$24.3 million in the comparable quarter ended September 30, 2006, as we continued to experience success of our new products, as well as continued growth with our existing product lines. Gross margins increased to 66% from 65% for the same quarter of 2006. Operating expenses increased 28% from the quarter ended September 30, 2006, representing 53% of total sales as compared to 51% in the third quarter of 2006. The increase in operating expense, as a percentage of sales, was primarily a result of our increased sales and marketing expenses due to a focus on promotion and marketing of our newly launched products, most notably the Novation<sup>®</sup> AHS Ceramic on Ceramic hip bearing system and the Equinoxe<sup>®</sup> Reverse Shoulder system. Net income for the quarter ended September 30, 2007 increased 35% and diluted earnings per share were \$0.21 as compared to \$0.16 last year. Included in these consolidated results of operations for the three months ended September 30, 2007, is a gain of \$37,000 from our subsidiary, Exactech Asia, and a loss of \$9,000 from our subsidiary, Exactech UK.

During the nine months ended September 30, 2007, sales increased 20% to \$91.1 million from \$76.3 million in the comparable period ended September 30, 2006, as we continued to experience growth across all of our major product lines, aided by the success in our new products. Gross margins remained constant at 64%, for each of the nine months ended September 30, 2007 and 2006. Operating expenses increased 26% from the nine months ended September 30, 2006, representing 53% of total sales as

compared to 50% in the first nine months of 2006. The increase was partially due to an impairment charge of \$1.5 million taken against our intangible assets, which increased operating expenses, as a percentage of sales by approximately 2%. Net income for the nine months ended September 30, 2007 increased 5% and diluted earnings per share were \$0.49 as compared to \$0.47 last year. Included in these consolidated results of operations for the nine months ended September 30, 2007, is a loss of \$42,000 from our subsidiary, Exactech Asia, and a loss of \$18,000 from our subsidiary, Exactech UK. If we exclude the pre-tax impairment charge of \$1.5 million, our net income would have increased 23% with a diluted earnings per share of \$0.57 for the nine months ended September 30, 2007. See "Non-GAAP Financial Measures" later in this section for further discussion on amounts excluding the impairment charge.

Our net inventory balance was reduced by \$605,000 from the year ended December 31, 2006, as we continue to make progress in managing our inventory while increasing net sales. During the nine months ended September 30, 2007, we acquired \$8.6 million in property and equipment, including a new building purchased during the first quarter, as well as new production equipment and surgical instrumentation. Cash flow from operations was \$16.0 million for the nine months ended September 30, 2007 as compared to \$7.0 million during the nine months ended September 30, 2006.

The following table includes the net sales and percentage of net sales for each of Exactech's product lines for the three and nine month periods ended September 30, 2007 and September 30, 2006:

**Sales by Product Line  
(dollars in thousands)**

	<b>Three Months Ended</b>				<b>Nine Months Ended</b>			
	<b>September 30, 2007</b>		<b>September 30, 2006</b>		<b>September 30, 2007</b>		<b>September 30, 2006</b>	
Knee Products	\$ 14,325	47.8%	\$ 12,030	49.5%	\$ 46,919	51.5%	\$ 40,311	52.9%
Hip Products	5,997	20.0	4,533	18.7	16,917	18.5	12,942	17.0
Biologics	4,228	14.1	3,373	13.9	11,634	12.8	9,679	12.7
Upper Extremity	2,434	8.1	1,130	4.6	6,356	7.0	3,533	4.6
Other Products	3,001	10.0	3,220	13.3	9,314	10.2	9,797	12.8
<b>Total</b>	<b>\$ 29,985</b>	<b>100.0%</b>	<b>\$ 24,286</b>	<b>100.0%</b>	<b>\$ 91,140</b>	<b>100.0%</b>	<b>\$ 76,262</b>	<b>100.0%</b>



## **Three and Nine Months Ended September 30, 2007 Compared to Three and Nine Months Ended September 30, 2006**

### **Sales**

For the quarter ended September 30, 2007, total sales increased 23% to \$30.0 from \$24.3 million in the comparable quarter ended September 30, 2006. Sales of knee implant products increased 19% during the quarter ended September 30, 2007 to \$14.3 million from \$12.0 million in the same quarter last year, primarily due to the contribution of the line extensions to our Optetrak<sup>®</sup> knee system, including hi-flex, asymmetric and rotating platform components. Hip implant sales of \$6.0 million during the quarter ended September 30, 2007 was an increase of 32% over the \$4.5 million in sales during the quarter ended September 30, 2006, primarily due to the continued momentum of our expanded Novation hip system. Sales from biologics increased 25% during the quarter ended September 30, 2007 to \$4.2 million, up from \$3.4 million in the comparable quarter in 2006, as our Optecure<sup>®</sup> service continues to gain market penetration, as does our Accelerate<sup>™</sup> platelet concentrating system. Sales from our upper extremity implants have increased 115% to \$2.4 million during the third quarter of 2007 as compared to \$1.1 million during the same period of 2006, as we benefited from the sales of our Equinox reverse shoulder system and continued to experience market shares gains with our primary system. Sales of all other products decreased to \$3.0 million as compared to \$3.2 million in the same quarter last year. Domestically, total sales increased 24% to \$24.6 million, or 82% of total sales, during the quarter ended September 30, 2007, up from \$19.9 million, which represented 82% of total sales, in the comparable quarter last year. Internationally, we continued to benefit from the expansion of the distribution of our products in Europe and Latin America as total international sales increased 21% to \$5.4 million, representing 18% of total sales, for the quarter ended September 30, 2007, as compared to \$4.4 million, which was 18% of total sales, for the same quarter in 2006.

For the nine months ended September 30, 2007, total sales increased 20% to \$91.1 from \$76.3 million in the comparable nine months ended September 30, 2006. Hip implant sales increased 31% to \$16.9 million during the nine months ended September 30, 2007, from \$12.9 million in sales during the nine months ended September 30, 2006, which was due to the continued momentum of our Novation hip system. Sales from biologics increased 20% during the nine months ended September 30, 2007 to \$11.6 million, up from \$9.7 million in the comparable period in 2006, as our Optecure service continued to drive the growth. Sales of knee implant products was \$46.9 million, an increase of 16% during the nine months ended September 30, 2007 from \$40.3 million in the same period last year, primarily resulting from the contribution of our line extensions to our Optetrak knee system. Sales from our upper extremity implants have increased 80% to \$6.4 million during the first nine months of 2007 as compared to \$3.5 million during the same period of 2006, as we continued to experience gains in market share with our primary Equinox implant system coupled with the initial introduction of our Equinox reverse shoulder system. Sales of all other products decreased to \$9.3 million as compared to \$9.8 million in the same period last year. Domestically, total sales increased 18% to \$70.6 million, or 77% of total sales, during the nine months ended September 30, 2007, up from \$59.6 million, which represented 78% of total sales, in the comparable period last year. Internationally, we continued to benefit from the expansion of the distribution of our products in Europe as international sales increased 24% to \$20.6 million, representing 23% of total sales, for the nine months ended September 30, 2007, as compared to \$16.6 million, which was 22% of total sales, for the same nine month period in 2006.

### **Gross Profit**

Gross profit increased 26% to \$19.9 million in the quarter ended September 30, 2007 from \$15.8 million in the quarter ended September 30, 2006. As a percentage of sales, gross profit increased to 66% during the quarter ended September 30, 2007 as compared to 65% in the quarter ended September 30, 2006, primarily due to our ongoing initiative to improve our manufacturing efficiencies and increase the volume of our implant components produced internally.

Our gross profit of \$58.5 million in the nine months ended September 30, 2007, represented an increase of 20% from \$48.8 million in the nine months ended September 30, 2006. As a percentage of sales, gross profit remained constant at 64% for both the nine months ended September 30, 2007 and 2006.

## **Operating Expenses**

Total operating expenses increased 28% to \$15.7 million in the quarter ended September 30, 2007 from \$12.3 million in the quarter ended September 30, 2006. As a percentage of sales, total operating expenses increased to 53% in the quarter ended September 30, 2007 from 51% in the comparable quarter ended September 30, 2006. Total operating expenses for the nine months ended September 30, 2007, increased 26% to \$48.3 million from \$38.2 million in the nine months ended September 30, 2006. As a percentage of sales, total operating expenses increased to 53% in the nine months ended September 30, 2007 from 50% in the comparable period ended September 30, 2006.

Sales and marketing expenses, the largest component of total operating expenses, increased 39% for the quarter ended September 30, 2007 to \$9.8 million from \$7.1 million in the same quarter last year, primarily due to our promotion and launch activities for several new products including our Novation AHS ceramic-on-ceramic hips system, Equinox reverse shoulder system, and variable selling expenses. As a percentage of sales, sales and marketing expenses were 33% during the quarter ended September 30, 2007, up from 29% in the same quarter last year. Sales and marketing expenses increased 28% for the nine months ended September 30, 2007 to \$28.2 million from \$22.1 million in the same period last year, primarily due to variable selling expenses and marketing costs associated with the introduction of new products. As a percentage of sales, sales and marketing expenses were 31% during the nine months ended September 30, 2007, up from 29% in the same nine months last year. Looking forward, sales and marketing expenditures, as a percentage of sales, are expected to remain in the range of 29% to 31% for the fourth quarter of 2007.

General and administrative expenses remained flat at \$2.4 million in the quarters ended September 30, 2007 and September 30, 2006. As a percentage of sales, general and administrative expenses decreased to 8% for the quarter ended September 30, 2007, as compared to 10% in the quarter ended September 30, 2006. General and administrative expenses increased 14% to \$8.3 million in the nine months ended September 30, 2007 from \$7.3 million in the nine months ended September 30, 2006, as a result of growth in operations and additional audit fees related to the year ended 2006. As a percentage of sales, general and administrative expenses decreased to 9% for the nine months ended September 30, 2007, as compared to 10% for the same period in 2006. General and administrative expenses for the balance of the year ending December 31, 2007 are expected to be in the range of 8% to 9%, as a percentage of sales.

Research and development expenses increased 43% for the quarter ended September 30, 2007 to \$2.0 million from \$1.4 million in the same quarter last year, as we continue to experience costs related to the clinical trial for the Optetrak RBK™ knee system. As a percentage of sales, research and development expenses increased to 7% for the quarter ended September 30, 2007 from 6% for the comparable quarter last year. Research and development expenses for the nine months ended September 30, 2007, increased 24% to \$5.7 million from \$4.6 million in the same nine-month period last year. As a percentage of sales, research and development expenses remained unchanged at 6% for the nine months ended September 30, 2007 and for the same period last year. As we continue to move ongoing development projects along, we expect research and development expenditures to continue to increase through the fourth quarter, ranging from 7% to 8% of sales.

Our operating expenses during the nine month period ended September 30, 2007, includes an impairment loss of \$1.5 million recognized during the second quarter, in association with the impairment of the full carrying value of a license to a patent we hold. The license is part of a purchase and distribution agreement that we entered into with Dimicron Corporation to market and distribute polycrystalline diamond compact hip bearings.

Depreciation and amortization increased 7% to \$1.5 million during the quarter ended September 30, 2007 from \$1.4 million in the quarter ended September 30, 2006, primarily as a result of continuing investment in surgical instrumentation and the expansion of our manufacturing operations. During the quarter ended September 30, 2007, we placed \$1.6 million of surgical instrumentation and \$677,000 of new manufacturing equipment in service. As a percentage of sales, depreciation and amortization decreased to 5% during the three month period ended September 30, 2007, as compared to 6% for the three month period ended September 30, 2006. Depreciation and amortization increased 7% to \$4.5 million during the nine months ended September 30, 2007 from \$4.2 million in the nine months ended September 30, 2006, primarily as a result of continuing investment in surgical instrumentation to support our new product launches. During the nine months ended September 30, 2007, we acquired a warehouse facility for \$715,000 in our existing complex, placed \$4.6 million of surgical instrumentation and \$1.3 million of new manufacturing equipment in service. As a percentage of sales, depreciation and amortization decreased to 5% for the nine month period ended September 30, 2007 from 6% for the nine month period ended September 30, 2006.

### **Income from Operations**

Our income from operations increased 19% to \$4.2 million in the quarter ended September 30, 2007 from \$3.5 million in the quarter ended September 30, 2006, as a result of improved sales during the quarter. Our income from operations decreased 4% in the nine months ended September 30, 2007, to \$10.2 million from \$10.6 million in the same period in 2006, primarily as a result of the intangible asset impairment loss taken during the second quarter of 2007. Looking forward, we anticipate income from operations to be in the range of 13% to 14% for the fourth quarter of 2007.

### **Other Income and Expenses**

Other expenses, net of other income, decreased to \$236,000 during the quarter ended September 30, 2007, from \$620,000 in the quarter ended September 30, 2006, primarily due to a reduction in interest expense on borrowings under the line of credit and other long-term debt. We incurred net interest expense for the quarter ended September 30, 2007 of \$232,000 as compared to \$571,000 during the quarter ended September 30, 2006. Other expenses, net of other income, decreased to \$897,000 during the nine months ended September 30, 2007, from \$1.6 million in the same period of the prior year, again, due to the reduction in interest expense. We incurred net interest expense for the nine months ended September 30, 2007 of \$845,000 as compared to \$1.6 million during the nine months ended September 30, 2006.

### **Equity Method Investee Gains and Losses**

Losses from our equity method investment in Altiva totaled \$113,000 for the quarter ended September 30, 2007 as compared to \$53,000 for the same quarter of 2006. Loss from our investment in Altiva was \$292,000 for the first nine months of 2007, as compared to a loss of \$167,000 for the same nine months of 2006. We anticipate that Altiva will reduce their comparative losses for the fourth quarter of 2007.

### **Taxes and Net Income**

Income before provision for income taxes increased 37% to \$3.9 million in the quarter ended September 30, 2007 from \$2.9 million in the quarter ended September 30, 2006. The effective tax rate, as a percentage of income before taxes, was 34% for the quarter ended September 30, 2007, as compared to 34% in the quarter ended September 30, 2006. Income before provision for income taxes increased 4% to \$9.3 million in the nine months ended September 30, 2007 from \$8.9 million in the nine months ended September 30, 2006. The effective tax rate, as a percentage of income before taxes, was 34% for the nine months ended September 30, 2007, as compared to 36% in the nine months ended September 30, 2006. The decrease in the effective tax rate for the nine months ended September 30, 2007 as compared to the same periods last year was primarily the result of an increase in anticipated credits related to research and development as well as domestic production activities. We expect our effective tax rates to range from 34% to 37% for the fourth quarter of 2007. Upon our adoption of FASB

Interpretation 48, "Accounting for Uncertain Tax Positions, an Interpretation of SFAS No. 109", on January 1, 2007, we evaluated the impact and determined that we did not have any uncertain tax positions requiring recognition as a result of the adoption of FIN 48. Our policy is to recognize interest and penalties accrued on uncertain tax positions as part of income tax expense. For the nine months ended September 30, 2007, no estimated interest or penalties were recognized for the uncertainty of certain tax positions.

As a result of the foregoing, we realized net income of \$2.5 million in the quarter ended September 30, 2007, an increase of 35% from \$1.8 million in the quarter ended September 30, 2006. As a percentage of sales, net income continued at 8% in the quarter ended September 30, 2007, from 8% in the quarter ended September 30, 2006. Earnings per share, on a diluted basis, increased to \$0.21 for the quarter ended September 30, 2007, from \$0.16 for the quarter ended September 30, 2006. Net income for the nine months ended September 30, 2007, increased 5% to \$5.8 million from net income of \$5.5 million for the same period in 2006. Diluted earnings per share increased to \$0.49 for the nine months ended September 30, 2007, from \$0.47 for the nine months ended September 30, 2006.

#### *Non-GAAP Financial Measures*

In addition to providing results that are determined in accordance with accounting principles generally accepted in the United States ("GAAP"), we have provided certain financial measures that are not in accordance with GAAP. Our non-GAAP financial measures of adjusted net income and adjusted diluted earnings per share exclude our intangible asset impairment less the tax effect of the impairment. Because the impairment is an infrequent non-cash item, 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 this unusual component included in GAAP financial measures.

Excluding the impact of the pre-tax charge of \$1.5 million for the intangible asset impairment recognized in the second quarter of 2007, net income for the nine months ended September 30, 2007, increased 23% to \$6.8 million, as compared to net income of \$5.5 million for the same nine months of 2006. Adjusted diluted earnings per share for the nine months of 2007 increased to \$0.57 as compared to diluted earnings per share of \$0.47 for the nine months of 2006.

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

	Three Month Periods Ended September 30,		Nine Month Periods Ended September 30,	
	2007	2006	2007	2006
Net Income	\$ 2,485	\$ 1,844	\$ 5,778	\$ 5,502
Adjustments for asset impairment charge				
Impairment loss, pre-tax	—	—	1,519	—
Income tax benefit	—	—	542	—
	—	—	977	—
Adjusted net income - excluding impairment charge	<u>\$ 2,485</u>	<u>\$ 1,844</u>	<u>\$ 6,755</u>	<u>\$ 5,502</u>
Diluted earnings per share	\$ 0.21	\$ 0.16	\$ 0.49	\$ 0.47
Adjustment of impairment charge, net	—	—	0.08	—
Adjusted diluted earnings per share	<u>\$ 0.21</u>	<u>\$ 0.16</u>	<u>\$ 0.57</u>	<u>\$ 0.47</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

Exactech has financed its operations through a combination of commercial debt financing, exercise of stock options and cash flows from its operating activities. At September 30, 2007, we had working capital of \$48.2 million, which is relatively unchanged from \$48.1 million at the end of 2006. Working capital in 2007 was affected by improved cash flow from operations, which was offset by our line of credit becoming due within a year and being classified into current liabilities. Our reduction in total inventory diminished as we continue to expand the market release of our Equinoxe reverse shoulder system and the ceramic bearing line extension for our Novation hip system. We hold certain inventory as non-current due to our estimation of inventory that we will not turn over within a twelve month period. We project that cash flows from operating activities and borrowing under our existing line of credit 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 \$16.0 million in the nine months ended September 30, 2007, as compared to a net cash flow from operations of \$7.0 million during the nine months ended September 30, 2006. This change was primarily related to an increase in our accounts payable balance as our purchasing increased in relation to our improved sales for the nine months of 2007. A partial offset to the operating cash inflow for the first nine months of 2007 was an increase in accounts receivable of \$4.2 million, which is also attributable to the sales growth. Our allowance for doubtful accounts and sales returns increased to \$816,000 at September 30, 2007 from \$572,000 at December 31, 2006 and the total days sales outstanding (DSO) ratio, based on average accounts receivable balances, improved for the nine months ended September 30, 2007 to 58 from a ratio of 65 for the nine months ended September 30, 2006. There have not been any significant changes in our credit terms and policies and we anticipate accounts receivable to continue to increase proportionately with sales growth. The increase in accounts payable and the non-cash asset impairment loss taken during the period ended September 30, 2007 provided aggregate net cash of \$6.6 million, in contrast to a usage in operating cash flow of \$3.8 million from accounts payable for the nine months ended September 30, 2006.

**Investing Activities** - Investing activities used net cash of \$10.7 million in the nine months ended September 30, 2007, as compared to \$5.4 million in the nine months ended September 30, 2006, primarily as a result of the additional purchases of surgical instrumentation and manufacturing equipment, as well as the acquisition of additional land and facilities for future expansion.

**Financing Activities** - Financing activities used net cash of \$6.5 million in the nine months ended September 30, 2007, as compared to \$1.9 million in net cash used for the nine months ended September 30, 2006. In the first nine months of 2007, we made net repayments under our credit line of \$6.0 million, as compared to net repayments of \$3.4 million in the first nine months of 2006. Our commercial debt facilities decreased by \$1.1 million as a result of repayments during the nine months ended September 30, 2007, as compared to \$606,000 in the first nine months of 2006. Proceeds from the exercise of stock options provided cash of \$697,000 in the nine months ended September 30, 2007, as compared to \$901,000 in the nine months ended September 30, 2006, and the proceeds were used to fund operating activities.

Exactech maintains a credit facility with Merrill Lynch Business Financial Services, Inc., which is secured by substantially all of Exactech's assets. The credit line is limited to a maximum amount of \$30.0 million less amounts owed by Altiva Corporation to Merrill Lynch, payment of which has been guaranteed by Exactech (as described below). However, the credit line limit may not exceed an amount equal to (a) the sum of 80% of the value of qualified accounts receivable, plus the lesser of (i) 50% of the value of finished goods inventory or (ii) \$17.0 million, less (b) the maximum amount of guaranteed obligations for the benefit of Altiva with respect to obligations owed by Altiva to Merrill Lynch. The credit line expires June 30, 2008. Borrowings under the Merrill Lynch credit facility bear interest at one-month LIBOR plus an applicable margin, which ranges from 1.5% to 2.38%, depending upon our ratio of funded debt to EBITDA. Under the above-described formulations, at September 30, 2007, a total of \$21.6 million was

available to borrow under the Exactech line of credit, of which, \$5.1 million had been borrowed, bearing interest currently at 6.9%, which is classified as current debt on our condensed consolidated balance sheet as of September 30, 2007.

In 1998, we entered into an industrial revenue bond financing secured by a letter of credit with a local lending institution for construction of our current facility. The balance due under the bond at September 30, 2007 was \$1.8 million bearing a variable rate of interest of 3.9%. In November 2002, Exactech 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, 2007, there was \$3.2 million outstanding under this loan bearing a variable rate of interest equal to 6.6%. In February 2003, we entered into an additional long-term loan of up to \$1.5 million, bearing interest at a rate of one month LIBOR plus 1.75% with a minimum rate equal to 3.5%, with a local lending institution for purposes of acquiring office and manufacturing equipment for our facility expansion. At September 30, 2007, \$432,000 was outstanding under this loan bearing a variable rate of interest equal to 6.9%. In October 2005, Exactech entered into a long-term loan of up to \$3.0 million, bearing interest at a rate of one month LIBOR plus 1.75% with a minimum rate equal to 5.6%, with a local lending institution for purposes of acquiring equipment for our remodeled manufacturing facility expansion. At September 30, 2007, \$2.4 million was outstanding under this loan bearing a variable rate of interest equal to 6.9%. 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, 2007, there was \$3.4 million outstanding under this loan.

Our credit facility and other loans contain customary affirmative and negative covenants including certain financial covenants with respect to Exactech's consolidated net worth, interest and debt coverage ratios and limits on capital expenditures and dividends in addition to other restrictions. We were in compliance with such covenants at September 30, 2007.

At September 30, 2007, Exactech had outstanding commitments for the purchase of inventory, raw materials and supplies of \$11.2 million and outstanding commitments for the purchase of capital equipment of \$666,000. We maintain several distribution agreements with third parties, of which we had \$7.8 million in purchases during the nine months ended September 30, 2007. During October 2007, we agreed with Waldemar Link to terminate our distribution agreement for Link hip, knee and ankle products effective December 31, 2007 primarily due to growth and profitability issues related to currency exchange. We have agreed with Waldemar Link to assist in the transition of the distribution of the Link products after the expiration of the agreement on December 31, 2007, and Waldemar Link will repurchase any inventory, including surgical instrumentation, that remains at the end of the year, which is currently estimated to be approximately \$7.8 million.

In October 2003, Exactech acquired a 16.7% minority interest in our equity method investee, Altiva Corporation. As part of the agreement, Exactech has committed to make loans available to Altiva in an amount not to exceed \$5.0 million for a period of five years, the proceeds of which shall be used for the acquisition of various spine and spine-related product lines. Funding obligations under this commitment are upon the request of Altiva's management and board of directors, and are subject to Exactech's reasonable discretion to approve the product line or technology acquisition(s) by Altiva to be funded by the loan(s) requested. As of September 30, 2007, Exactech had extended to Altiva the principal sum of \$4.4 million under this commitment, bearing interest currently at 8.9%. These loans are due in four equal annual installments beginning November 1, 2009 through November 1, 2012. At Exactech's election any time between October 29, 2005 and October 28, 2008, these loans can be converted by Exactech into shares of Altiva's Series C Preferred Stock, par value \$.01 (the "Series C Stock"), of Altiva, a newly-created class of Altiva's capital stock of which Exactech is the only holder. The conversion ratio of the loans is structured such that if Exactech loans the full \$5.0 million commitment, the conversion of all outstanding balances under the loans combined with shares of Series C Stock Exactech received in connection with its original investment, will give Exactech a 54.5% interest in Altiva. If less than a \$5

million amount of principal is outstanding under the loan at the time Exactech elects to convert, the number of shares issued is subject to a proportionate adjustment. The Series C Stock to be issued to Exactech upon conversion of the loan is held solely by Exactech and has identical rights and privileges to the common stock of Altiva except that the Series C Stock has a superior liquidation preference with respect to dividends and upon liquidation of Altiva (up to the extent of Exactech's investment in Altiva) and is convertible on a 1-for-1 basis into shares of Altiva's common stock.

In addition, Exactech has committed to provide Altiva with, or guarantee on behalf of Altiva, a working capital credit line in an amount up to \$6.0 million, which is collateralized by substantially all of Altiva's assets, subject to the prior liens of the lender that provides the working capital line to Altiva. Pursuant to this commitment, Exactech has guaranteed a \$6 million line of credit with Merrill Lynch. This guarantee is limited to a principal amount not to exceed \$6 million and a term not to exceed October 30, 2008. As of September 30, 2007, there was \$6.0 million borrowed under this line. Based upon the expected present values of probability weighted future cash flows of Altiva pursuant to requirements in FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees Including Indirect Guarantees of Indebtedness of Others", the Company has recorded a liability of \$252,000 related to its guarantee of Altiva's debt with Merrill Lynch pursuant to this commitment.

Exactech, Altiva, all other holders of Altiva's preferred stock and certain officers of Altiva have also entered into a stockholders agreement under the terms of which Exactech was granted an option, exercisable any time between October 29, 2005 and October 28, 2008, to purchase all of the outstanding shares of Altiva's common stock, preferred stock and securities that are convertible into common stock or preferred stock, or all or substantially all of the assets of Altiva. The purchase price payable under this buyout option will be equal to 80% of the valuation of Altiva's business, which valuation is subject to a floor of \$25.0 million and adjustments for the amounts of indebtedness, cash and cash equivalents and accounts payable Altiva holds at the time the purchase price is calculated. The stockholders agreement provides that the Altiva valuation will be calculated by applying a buyout multiple to Altiva's trailing twelve months revenue as of the date the purchase price is calculated. This buyout multiple is calculated by reference to an "Exactech Multiple" which is calculated by dividing Exactech's average stock price for the preceding 90 days by Exactech's trailing twelve months revenue per share. Under the formulations set forth in the stockholders agreement with respect to the relationship between the buyout multiple and the Exactech Multiple, the buyout multiples would range from 1.5 to 4.0 based on the Exactech Multiple at that time.

Each interim period, Exactech evaluates its investment in Altiva pursuant to FASB Interpretation No. 46, "Consolidation of Variable Interest Entities", as revised ("FIN 46R") to determine if the fair value of the equity investment, guarantee of a line of credit and commitment to fund convertible debt constitutes more than 50% of the fair value of Altiva's total equity, subordinated debt and other forms of subordinated financial support. Exactech has evaluated its investment in Altiva Corporation at September 30, 2007 in accordance with the provisions of FIN 46R, and based upon this analysis, has determined that Altiva does not qualify as a variable interest entity requiring consolidation.

During 2006, Exactech began providing Biologic products to Altiva Corporation on consignment for distribution to unaffiliated third parties. We recognize service revenues upon Altiva's distribution of these products to the unaffiliated third parties. For biologic products that were distributed through Altiva we recorded revenues of \$545,000 and \$843,000 for the three and nine months ended September 30, 2007, respectively. Their accounts receivable balance as of September 30, 2007, was \$545,000.

#### **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 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 2006 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

Exactech is 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 Exactech's 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 \$4,000 for the remainder of 2007. We believe that the amounts presented approximate the financial instruments' fair market value as of September 30, 2007, and the weighted average interest rates are those experienced during the year to date ended September 30, 2007 (in thousands, except percentages):

	2007	2008	2009	2010	Thereafter	Total
<b>Cash and cash equivalents</b>						
Overnight repurchase account at variable interest rate	\$ 653	\$ —	\$ —	\$ —	\$ —	\$ 653
Weighted average interest rate	3.8 %					
<b>Liabilities</b>						
Industrial Revenue Bond at variable interest rate	\$ 200	\$ 200	\$ 200	\$ 200	\$ 1,000	\$ 1,800
Weighted average interest rate	3.8 %					
Commercial construction loan at variable interest rate	53	210	210	210	2,515	3,198
Weighted average interest rate	6.8 %					
Commercial equipment loan at variable interest rate	76	305	51	—	—	432
Weighted average interest rate	7.1 %					
Commercial equipment loan at variable interest rate	148	594	594	594	447	2,377
Weighted average interest rate	7.1 %					
Commercial real estate loan at fixed rate swap	85	337	360	386	2,255	3,423
Weighted average interest rate	6.6 %					
Line of credit at variable interest rate	—	5,088	—	—	—	5,088
Weighted average interest rate	7.2 %					

Exactech invoices and receives payment from international distributors in U. S. dollars and is not subject to risk associated with international currency exchange rates on accounts receivable. The functional currency of our Chinese subsidiary, Exactech Asia, is the Chinese Yuan Renminbi (CNY). Transactions are translated into U.S. dollars and exchange gains and losses arising from translation are recognized in "Other comprehensive income (loss)". During the three and nine months ended September 30, 2007 and 2006, translation losses were not significant. Exactech may experience translation gains and losses during the year ending December 31, 2007; however, these gains and losses are not expected to have a material effect on Exactech's financial position, results of operations, or cash flows.

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 Exactech's primary currency, and transactions that are completed in an international currency are translated into U.S. dollars and

recorded in the financial statements. Foreign currency transaction losses for the first nine months of 2007 were \$52,000 as compared to \$95,000 during the same period in 2006, primarily due to the strength of the Euro as compared to the U.S. dollar. 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**

- (a) Evaluation of disclosure controls and procedures** – Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our disclosure controls and procedures as of September 30, 2007. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of September 30, 2007, to ensure that the information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.
- (b) Changes in internal control** – There were no changes in our internal control over financial reporting that occurred during the three months ended September 30 2007, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

There are various claims, lawsuits, and disputes with third parties and pending actions involving various allegations against the Company incident to the operation of the business, principally product liability cases. We recently settled a product liability suit filed in Madrid, Spain, for \$13,000, which was paid during the third quarter of 2007. We are currently a party to several products liability suits related to the products distributed by Exactech on behalf of Regeneration Technologies, Inc. ("RTI"). Pursuant to our license and distribution agreement with RTI, we will tender all cases to RTI. While we believe that these cases are without merit, we are unable to predict the outcome of this or other such litigation. Therefore, we maintain product liability insurance, subject to self-insured retention limits, for these and all such claims, and establish accruals for product liability and other claims, based upon our experience with past claims, advice of counsel, and the best information available. At September 30, 2007, our accrual for product liability claims decreased \$220,000 from December 31, 2006, primarily as a result of the resolution of the case in Madrid, Spain and resolution of certain other claims. Certain matters are subject to various uncertainties, and it is possible that those matters may be resolved unfavorably to us. However, while it is not possible to predict with certainty the outcome of these types of claims, it is the opinion of management that, upon ultimate resolution, these matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

Exactech's 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.

### **Item 1A. Risk Factors**

Information about risk factors for the nine months ended September 30, 2007, does not differ materially from those in set forth in Part I, Item 1A, of Exactech's annual report on Form 10-K for the year ended December 31, 2006.

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

None

### **Item 3. Defaults Upon Senior Securities**

None

### **Item 4. Submission of Matters to a Vote of Security Holders**

None

### **Item 5. Other Information**

None

**Item 6. Exhibits**

(a) Exhibits

- 3.1 Company's Articles of Incorporation, as amended(1)
  - 3.2 Company's Bylaws (1)
  - 3.3 Forms of Articles of Amendment to Articles of Incorporation(1)(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.
- 
- (1) Incorporated by reference to the exhibit of the same number filed with the Registrant's Registration Statement on Form S-1 (File No. 333-02980).
  - (2) Incorporated by reference to exhibit 3 filed with the Registrants' Quarter Report on Form 10-Q for the quarter ended March 31, 2003.

## 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 7, 2007

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

Date: November 8, 2007

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 7, 2007

/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, 2007

/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, 2007 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 7, 2007

**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, 2007 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, 2007