

VCA ANTECH INC  
Form 10-Q/A  
September 10, 2003

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

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**FORM 10-Q/A**  
**Amendment No. 1**

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

For the quarterly period ended June 30, 2003

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

**Commission File Number: 001-16783**

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**VCA ANTECH, INC.**  
*(Exact name of registrant as specified in its charter)*

**Delaware**  
*(State or other jurisdiction of  
incorporation or organization)*

**95-4097995**  
*(I.R.S. Employer  
Identification No.)*

**12401 West Olympic Boulevard**  
**Los Angeles, California 90064-1022**  
*(Address of principal executive offices)*

**(310) 571-6500**  
*(Registrant's telephone number, including area code)*

**Securities registered pursuant to Section 12(b) of the Act:**

None

**Securities registered pursuant to Section 12(g) of the Act:**

Common stock, \$0.001 par value

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No .

Indicate the number of shares outstanding of each of the issuer's class of common stock as of the latest practicable date: Common stock, \$0.001 par value 40,640,159 shares as of August 11, 2003.



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**EXPLANATORY NOTE**

This Amendment No. 1 to Form 10-Q for the period ended June 30, 2003, is being made in order to revise Item 4 of Part I, the certifications required by Section 302 of the Sarbanes-Oxley Act of 2002 (Exhibits 31.1 and 31.2) and the certifications required by Section 906 of the Sarbanes-Oxley Act of 2002 (Exhibit 32.1) to incorporate those amendments set forth in the Securities and Exchange Commission's Release No. 33-8283 which were inadvertently omitted from our original filing on August 13, 2003.

Except for the items described above, none of the information contained in our original filing on Form 10-Q has been updated, modified or revised. The remainder of our original report on Form 10-Q is included herein for the convenience of the reader.

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FORM 10-Q  
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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**CONDENSED, CONSOLIDATED BALANCE SHEETS**  
**As of June 30, 2003 and December 31, 2002**  
**(Unaudited)**  
**(In thousands, except par value)**

	<b>June 30, 2003</b>	<b>December 31, 2002</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 22,512	\$ 6,462
Trade accounts receivable, less allowance for uncollectible accounts of \$6,550 and \$6,408 at June 30, 2003 and December 31, 2002, respectively	25,537	20,727
Inventory, prepaid expenses and other	8,593	8,643
Deferred income taxes	10,405	9,528
Prepaid income taxes	2,704	7,614
	<hr/>	<hr/>
Total current assets	69,751	52,974
Property and equipment, net	96,845	95,303
Other assets:		
Goodwill, net	363,229	342,614
Covenants not to compete, net	5,041	4,735
Deferred financing costs, net	5,952	6,778
Other	4,435	5,024
	<hr/>	<hr/>
Total assets	\$ 545,253	\$ 507,428
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<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Current portion of long-term obligations	\$ 2,698	\$ 9,622
Accounts payable	10,130	10,223
Accrued payroll and related liabilities	12,538	14,734
Accrued interest	1,533	1,565
Other accrued liabilities	18,440	13,464
	<hr/>	<hr/>
Total current liabilities	45,339	49,608
Long-term obligations, less current portion	335,792	371,935
Deferred income taxes	19,028	15,376
Other liabilities	2,007	2,007
Minority interest	5,138	5,416
Stockholders equity:		
Common stock, par value \$0.001, 75,000 shares authorized, and 40,633 and 36,765 shares outstanding as of June 30, 2003 and December 31, 2002, respectively	41	37
Additional paid-in capital	243,327	188,941
Accumulated deficit	(105,221)	(125,754)
Accumulated comprehensive loss - unrealized loss on hedging instruments	(103)	
Notes receivable from stockholders	(95)	(138)
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Total stockholders equity	137,949	63,086

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Total liabilities and stockholders equity	\$ 545,253	\$ 507,428
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The accompanying notes are an integral part of these condensed, consolidated financial statements.



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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**CONDENSED, CONSOLIDATED STATEMENTS OF OPERATIONS**  
**For the Three and Six Months Ended June 30, 2003 and 2002**  
**(Unaudited)**  
**(In thousands, except per share amounts)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenue	\$ 132,363	\$ 117,225	\$ 248,363	\$ 221,920
Direct costs (excludes operating depreciation of \$2,665 and \$2,360 for the three months ended June 30, 2003 and 2002, respectively, and \$5,419 and \$4,608 for the six months ended June 30, 2003 and 2002, respectively)	86,504	77,004	166,255	149,592
	45,859	40,221	82,108	72,328
Selling, general and administrative expense	9,090	8,539	18,453	17,161
Depreciation and amortization	3,497	3,139	7,074	6,302
Loss (gain) on sale of assets	78		(160)	
Operating income	33,194	28,543	56,741	48,865
Interest expense, net	6,418	10,344	13,410	20,333
Debt retirement costs			7,417	
Other (income) expense	131	(61)	258	(154)
Minority interest in income of subsidiaries	462	528	823	930
Income before provision for income taxes	26,183	17,732	34,833	27,756
Provision for income taxes	10,833	7,237	14,300	11,626
Net income	\$ 15,350	\$ 10,495	\$ 20,533	\$ 16,130
Basic earnings per common share	\$ 0.38	\$ 0.29	\$ 0.52	\$ 0.44
Diluted earnings per common share	\$ 0.37	\$ 0.28	\$ 0.51	\$ 0.43
Shares used for computing basic earnings per share	40,606	36,739	39,818	36,738
Shares used for computing diluted earnings per share	41,136	37,087	40,288	37,084

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

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**CONDENSED, CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For the Six Months Ended June 30, 2003 and 2002**  
**(Unaudited)**  
**(In thousands)**

	Six Months Ended June 30,	
	2003	2002
Cash flows from operating activities:		
Net income	\$ 20,533	\$ 16,130
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,074	6,302
Amortization of deferred financing costs and debt discount	456	847
Provision for uncollectible accounts	1,557	1,420
Debt retirement costs	7,417	
Interest paid in kind on 15.5% senior notes		4,645
Gain on sale of assets	(160)	
Minority interest in income of subsidiaries	823	930
Distributions to minority interest partners	(797)	(805)
Increase in trade accounts receivable	(5,351)	(5,845)
Decrease (increase) in inventory, prepaid expenses and other assets	168	(362)
Increase in accounts payable and other accrued liabilities	1,343	825
Decrease in accrued payroll and related liabilities	(2,196)	(238)
Decrease in accrued interest	(32)	(270)
Decrease in prepaid income taxes	4,910	2,782
Increase in income taxes payable		1,901
Increase in deferred income taxes asset	(877)	(946)
Increase in deferred income taxes liability	3,652	4,498
Net cash provided by operating activities	38,520	31,814
Cash flows from investing activities:		
Business acquisitions, net of cash acquired	(19,926)	(9,997)
Real estate acquired in connection with business acquisitions	(589)	
Property and equipment additions, net	(6,168)	(6,204)
Proceeds from sale of assets	355	
Other	361	129
Net cash used in investing activities	(25,967)	(16,072)
Cash flows from financing activities:		
Repayment of long-term obligations, including redemption fees	(50,511)	(2,485)
Payment of deferred financing and recapitalization costs	(382)	(2,673)
Proceeds from issuance of common stock under stock option plans	67	17
Proceeds from issuance of common stock	54,323	
Net cash provided by (used in) financing activities	3,497	(5,141)
Increase in cash and cash equivalents	16,050	10,601
Cash and cash equivalents at beginning of period	6,462	7,103

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Cash and cash equivalents at end of period	\$ 22,512	\$ 17,704
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The accompanying notes are an integral part of these condensed, consolidated financial statements.

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2003**  
**(Unaudited)**

**(1) General**

The accompanying unaudited condensed, consolidated financial statements of VCA Antech, Inc. and subsidiaries (the Company or VCA ) have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and in accordance with the rules and regulations of the United States Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements as permitted under applicable rules and regulations. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. The results of operations for the three and six months ended June 30, 2003 are not necessarily indicative of the results to be expected for the full year. For further information, refer to the Company's consolidated financial statements and footnotes thereto included in the Company's 2002 Annual Report on Form 10-K.

**(2) Acquisitions**

During the three months ended June 30, 2003, the Company purchased 11 animal hospitals and five veterinary diagnostic laboratories. Five of the acquired animal hospitals and two of the acquired laboratories were merged into existing VCA facilities upon acquisition. Including acquisition costs, the Company paid an aggregate consideration of \$16.4 million, consisting of \$13.8 million in cash, \$2.3 million in an obligation to be settled in either cash or shares of the Company's common stock, and \$385,000 in certain obligations to sellers and other liabilities assumed. The \$16.4 million aggregate purchase price was allocated as follows: \$1.1 million to tangible assets, \$14.6 million to goodwill and \$791,000 to other intangible assets. Goodwill was assigned to the animal hospital and laboratory reporting units in the amounts of \$8.6 million and \$6.0 million, respectively. The Company expects that \$6.5 million of the goodwill recorded will be fully deductible for income tax purposes.

During the six months ended June 30, 2003, the Company purchased 16 animal hospitals and six veterinary diagnostic laboratories. Five of the acquired animal hospitals and two of the acquired laboratories were merged into existing VCA facilities upon acquisition. Including acquisition costs, the Company paid an aggregate consideration of \$22.5 million, consisting of \$19.4 million in cash, \$2.3 million in an obligation to be settled in either cash or shares of the Company's common stock, and \$907,000 in certain obligations to sellers and other liabilities assumed. The \$22.5 million aggregate purchase price was allocated as follows: \$1.2 million to tangible assets, \$20.1 million to goodwill and \$1.2 million to other intangible assets. Goodwill was assigned to the animal hospital and laboratory reporting units in the amounts of \$13.8 million and \$6.3 million, respectively. The Company expects that \$11.0 million of the goodwill recorded will be fully deductible for income tax purposes.

During the six months ended June 30, 2003, the Company purchased the total ownership interest of partners in two non-wholly owned subsidiaries of the Company for approximately \$910,000, consisting of \$106,000 in cash, \$763,000 in a note payable, and \$41,000 in the forgiveness of certain notes owed to the Company by the partner. The Company recorded goodwill of \$362,000 related to the purchase and expects that it will be fully deductible for income tax purposes.

The Company also made payments of \$465,000 during the six months ended June 30, 2003 related to certain other obligations incurred at the time of acquisition.

**Table of Contents****(3) Calculation of Earnings per Common Share**

Basic and diluted earnings per common share were computed as follows (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net income	\$ 15,350	\$ 10,495	\$ 20,533	\$ 16,130
Weighted average common shares outstanding:				
Basic	40,606	36,739	39,818	36,738
Effect of dilutive common shares:				
Stock options	494	348	452	346
Contracts that may be settled in stock or cash	36		18	
Diluted	41,136	37,087	40,288	37,084
Earnings per common share:				
Basic	\$ 0.38	\$ 0.29	\$ 0.52	\$ 0.44
Diluted	\$ 0.37	\$ 0.28	\$ 0.51	\$ 0.43

**(4) Comprehensive Income**

Below is a calculation of comprehensive income (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net income	\$ 15,350	\$ 10,495	\$ 20,533	\$ 16,130
Unrealized gain (loss) on hedging instruments	(114)	590	(114)	1,050
Less portion of unrealized loss (gain) recognized	11	(61)	11	(154)
Net comprehensive income	\$ 15,247	\$ 11,024	\$ 20,430	\$ 17,026

All unrealized gains and losses presented are the result of changes in the fair market value of interest rate hedging agreements (see footnote 5, *Interest Rate Hedging Agreements*). The agreements are two-year agreements that will have zero market value at the end of their terms. Accordingly, all unrealized gains and losses will net to zero over the life of the contract. As a result, the Company has not recognized an income tax expense or benefit relating to these gains and losses.

**Table of Contents****(5) Interest Rate Hedging Agreements**

The Company entered into the following no-fee swap agreements ( Swap Agreements ), which swap monthly variable London interbank offer rates ( LIBOR ) for the fixed rates indicated below:

	Swap #1	Swap #2	Swap #3
Fixed interest rate	2.22%	1.72%	1.51%
Notional amount	\$40.0 million	\$20.0 million	\$20.0 million
Effective date	11/29/2002	5/30/2003	5/30/2003
Expiration date	11/29/2004	5/31/2005	5/31/2005
Counter party	Wells Fargo Bank	Wells Fargo Bank	Goldman Sachs

Swap #2 and Swap #3 qualify for hedge accounting and the Company considers these to be cash flow hedging instruments. However, in May 2003 management determined that Swap #1 was no longer an effective tool to hedge against interest rate risk because LIBOR projections were considerably below the initial LIBOR forecasts used to price the swap at inception of the contract. As a result of this determination, Swap #1 no longer qualifies for hedge accounting and all changes in its market value are recognized as income or expense in the period of change.

On November 13, 2000, the Company entered into a no-fee interest rate collar agreement with Wells Fargo Bank, which expired on November 15, 2002, ( Collar Agreement ). The Collar Agreement reset monthly and had a cap and floor notional amount of \$62.5 million with a cap and floor interest rate of 7.5% and 5.9%, respectively. The Collar Agreement qualified for hedge accounting and the Company considered it a cash flow hedging instrument.

The valuations of the Swap Agreements and the Collar Agreement were determined by the counter parties. At June 30, 2003 and December 31, 2002, the fair market values of the Swap Agreements resulted in a liability from interest rate hedging activities of \$674,000 and \$313,000, respectively. As a result of the Company's interest rate hedging activities, it recognized an unrealized loss of \$131,000 and an unrealized gain of \$61,000 during the three months ended June 30, 2003 and 2002, respectively, and it recognized an unrealized loss of \$258,000 and an unrealized gain of \$154,000 during the six months ended June 30, 2003 and 2002, respectively. These charges have been reported as part of other (income) expense.

The Company made payments under the Swap Agreements amounting to \$102,000 for the three months ended June 30, 2003 and \$187,000 for the six months ended June 30, 2003, resulting from LIBOR being below the fixed interest rate. The Company made payments under the Collar Agreement amounting to \$639,000 for the three months ended June 30, 2002 and \$1.3 million for the six months ended June 30, 2002 resulting from LIBOR being below the floor interest rate of 5.9%. These payments have been reported as part of interest expense.

**(6) Lines of Business**

During the three and six months ended June 30, 2003 and 2002, the Company had three reportable segments: Laboratory, Animal Hospital and Corporate. These segments are strategic business units that have different products, services and functions. The segments are managed separately because each is a distinct and different business venture with unique challenges, rewards and risks. The Laboratory segment provides testing services for veterinarians both associated with the Company and independent of the Company. The Animal Hospital segment provides veterinary services for companion animals and sells related retail and pharmaceutical products. Corporate provides selling, general and administrative support for the other two segments.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies as detailed in the Company's consolidated financial statements and footnotes thereto included in the 2002 Annual Report on Form 10-K. The Company evaluates performance of segments based on operating income. For purposes of reviewing the operating performance of the segments, all intercompany sales and purchases are accounted for as if they were transactions with independent third parties at current market prices.

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Below is a summary of certain financial data for each of the three segments (in thousands):

	<u>Laboratory</u>	<u>Animal Hospital</u>	<u>Corporate</u>	<u>Intercompany Eliminations</u>	<u>Total</u>
<b>Three Months Ended June 30, 2003</b>					
Revenue	\$ 46,691	\$ 88,424	\$	\$(2,752)	\$ 132,363
Direct costs (excluding operating depreciation)	24,816	64,440		(2,752)	86,504
Selling, general and administrative	2,797	2,519	3,774		9,090
Loss (gain) on sale of assets	21	58	(1)		78
Depreciation and amortization	799	2,304	394		3,497
Operating income (loss)	<u>\$ 18,258</u>	<u>\$ 19,103</u>	<u>\$ (4,167)</u>	<u>\$</u>	<u>\$ 33,194</u>
Capital expenditures	\$ 590	\$ 2,165	\$ 588	\$	\$ 3,343
<b>Three Months Ended June 30, 2002</b>					
Revenue	\$ 40,604	\$ 78,621	\$ 500	\$(2,500)	\$ 117,225
Direct costs (excluding operating depreciation)	22,134	57,370		(2,500)	77,004
Selling, general and administrative	2,396	2,478	3,665		8,539
Depreciation and amortization	726	2,069	344		3,139
Operating income (loss)	<u>\$ 15,348</u>	<u>\$ 16,704</u>	<u>\$ (3,509)</u>	<u>\$</u>	<u>\$ 28,543</u>
Capital expenditures	\$ 825	\$ 1,818	\$ 393	\$	\$ 3,036
<b>Six Months Ended June 30, 2003</b>					
Revenue	\$ 88,389	\$ 165,152	\$	\$(5,178)	\$ 248,363
Direct costs (excluding operating depreciation)	48,272	123,161		(5,178)	166,255
Selling, general and administrative	5,504	5,022	7,927		18,453
Loss (gain) on sale of assets	19	(178)	(1)		(160)
Depreciation and amortization	1,553	4,781	740		7,074
Operating income (loss)	<u>\$ 33,041</u>	<u>\$ 32,366</u>	<u>\$ (8,666)</u>	<u>\$</u>	<u>\$ 56,741</u>
Capital expenditures	\$ 1,764	\$ 3,358	\$ 1,046	\$	\$ 6,168
<b>Six Months Ended June 30, 2002</b>					
Revenue	\$ 78,261	\$ 147,265	\$ 1,000	\$(4,606)	\$ 221,920
Direct costs (excluding operating depreciation)	43,696	110,502		(4,606)	149,592
Selling, general and administrative	5,069	4,992	7,100		17,161
Depreciation and amortization	1,423	4,205	674		6,302
Operating income (loss)	<u>\$ 28,073</u>	<u>\$ 27,566</u>	<u>\$ (6,774)</u>	<u>\$</u>	<u>\$ 48,865</u>
Capital expenditures	\$ 1,430	\$ 3,955	\$ 819	\$	\$ 6,204
<b>At June 30, 2003</b>					
Identifiable assets	\$ 130,146	\$ 365,880	\$ 49,227	\$	\$ 545,253
<b>At December 31, 2002</b>					

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Identifiable assets	\$ 117,443	\$ 350,980	\$ 39,005	\$	\$ 507,428
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Below is a reconciliation between total segment operating income after eliminations and consolidated income before provision for income taxes as reported on the condensed, consolidated statements of operations (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Total segment operating income after eliminations	\$33,194	\$28,543	\$56,741	\$48,865
Interest expense, net	6,418	10,344	13,410	20,333
Debt retirement costs			7,417	
Other (income) expense	131	(61)	258	(154)
Minority interest in income of subsidiaries	462	528	823	930
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Income before provision for income taxes	\$26,183	\$17,732	\$34,833	\$27,756
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

**(7) Secondary Offering and Debt Retirement**

In February 2003, the Company completed a secondary offering of 10.1 million shares of its common stock. As part of this offering, the Company granted its underwriters an over-allotment option to purchase an additional 1.5 million shares of its common stock that was exercised in full in February 2003. In conjunction with these transactions, the Company sold 3.8 million primary shares of its common stock in exchange for net proceeds of approximately \$54.3 million. The Company used approximately \$42.7 million of the net proceeds to voluntarily retire the remaining principal amount outstanding of its 15.5% senior notes due 2010 at a price of 110% of the principal amount plus accrued and unpaid interest resulting in debt retirement costs of approximately \$7.4 million. The Company is using the remaining \$11.6 million of net proceeds for general corporate purposes.

**(8) Goodwill and Other Intangible Assets**

Goodwill represents the purchase price paid and the fair market value of liabilities assumed for animal hospital and laboratory acquisitions in excess of the fair market value of the net assets acquired. Other intangible assets represent covenants not to compete and client lists, both of which are associated with acquisitions.

The following table presents the changes in the carrying amount of goodwill for the six months ended June 30, 2003 (in thousands):

	Laboratory	Animal Hospital	Total
Balance as of January 1, 2003	\$87,313	\$255,301	\$342,614
Goodwill acquired and purchase price adjustments	6,321	14,294	20,615
	<u>          </u>	<u>          </u>	<u>          </u>
Balance as of June 30, 2003	\$93,634	\$269,595	\$363,229
	<u>          </u>	<u>          </u>	<u>          </u>

In addition to goodwill, the Company has other intangible assets as follows (in thousands):

	As of June 30, 2003		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Covenants not to compete	\$12,924	\$(7,883)	\$5,041
Client lists	592	(499)	93

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Total	<u>\$13,516</u>	<u>\$(8,382)</u>	<u>\$5,134</u>
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The aggregate amortization related to other intangible assets was as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Aggregate amortization expense	\$ 438	\$ 435	\$ 915	\$ 1,020

Based on balances at June 30, 2003, estimated amortization expense for other intangible assets for the current year and the next four fiscal years is as follows (in thousands):

2003	\$ 1,815
2004	\$ 1,478
2005	\$ 1,087
2006	\$ 712
2007	\$ 501

**(9) Accounting Pronouncements****a. Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity**

In May 2003, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. SFAS No. 150 clarifies the accounting for certain financial instruments with characteristics of both liabilities and equity and requires that those instruments be classified as liabilities. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company currently has a \$2.3 million obligation to be settled in either cash or common stock that is classified as a liability. It does not have any immediate plans to enter into other financial instruments subject to the accounting requirements of SFAS No. 150. The adoption of SFAS No. 150 will not have a material impact on the Company's financial statements.

**b. Accounting for Derivative Instruments and Hedging Activities**

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 clarifies financial accounting and reporting requirements for derivative instruments and hedging activities as set forth under SFAS No. 133. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships entered into after June 30, 2003. The adoption of SFAS No. 149 will not have a material impact on the Company's financial statements.

**c. Consolidations of Variable Interest Entities**

In January 2003, the FASB issued FASB Interpretation ( FIN ) No. 46, *Consolidation of Variable Interest Entities*, requiring that companies consolidate variable interest entities if they are the primary beneficiaries, as defined under FIN No. 46, of the activities of the variable interest entities. Companies are required to apply FIN No. 46 immediately for all variable interest entities created after January 31, 2003 and as of the beginning of the first interim period beginning after June 15, 2003 for all other variable interest entities.

The Company provides management services to certain veterinary medical groups in states with laws that prohibit business corporations from providing, or holding themselves out as providers of, veterinary medical care. As of June 30, 2003, the Company operated in 11 of these states. In these states, the Company provides management services to veterinary medical groups pursuant to long-term management agreements (the Management Agreements ), ranging from 10 to 40 years with non-binding renewal options, where allowable. Pursuant to these Management Agreements, the veterinary medical groups are each solely responsible for all aspects of veterinary medicine, as defined by their respective state. The Company provides administrative and other support services.

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Currently, the Company does not consolidate the operations of the veterinary medical groups since it has no ownership interests in them. However, the Company is finalizing its analysis of FIN No. 46, and it is reasonably possible that the operations of the veterinary medical groups will be consolidated. If the veterinary medical groups were to be consolidated into the Company's operating results, there would be no effect on operating income and the Company would not be exposed to additional losses. A comparative analysis of the Company's animal hospital operations both as currently reported and as would be reported if we consolidated the veterinary medical groups is as follows (in thousands):

	<b>For the Six Months Ended June 30, 2003</b>		
	<b>As Reported</b>	<b>As Consolidated</b>	<b>Difference</b>
Revenue	\$ 165,152	\$ 185,129	\$ 19,977
Direct costs (excluding operating depreciation)	\$ 123,161	\$ 143,138	\$ 19,977
Operating income	\$ 32,366	\$ 32,366	\$

**d. Guarantor's Accounting and Disclosure Requirements for Guarantees**

In January 2003, the FASB issued FIN No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN No. 45 requires a company to recognize a liability for the obligations it has undertaken in issuing a guarantee. This liability would be recorded at the inception of a guarantee and would be measured at fair value. The measurement provisions of this statement apply prospectively to guarantees issued or modified after December 31, 2002 for periods ending after December 15, 2002. The Company does not have any obligations subject to the provisions of FIN No. 45.

**e. Consideration Received from a Vendor**

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus regarding two issues raised by EITF Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*. The EITF concluded that:

cash received by a vendor is presumed to be a reduction of the cost of the vendor's products or services, however that presumption is overcome when the consideration is either a) payment for assets or services, in which case the consideration is characterized as revenue, or b) a reimbursement of specific and identifiable costs incurred on behalf of the vendor in selling the vendor's products or services, in which case the consideration is a reduction of that cost; and

rebates offered to a customer or reseller should be recognized as a reduction of the cost of sales based on a systematic and rational allocation provided that the amounts recognized are probable and reasonably estimable.

EITF Issue No. 02-16 is effective for changes made to existing agreements or new agreements entered into on or after January 1, 2003. The Company adopted EITF Issue No. 02-16 on January 1, 2003 without a material impact on its financial statements and does not expect it to have a material impact on its financial statements in the future.

**f. Costs Associated with Exit or Disposal Activities**

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 requires that liabilities associated with exit or disposal activities be recognized when a company is committed to future payment of those liabilities under a binding, legal obligation. SFAS No. 146 nullifies EITF No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, which required that exit and disposal costs be recognized as liabilities when a company formalized its plan for exiting or disposing of an activity even if no legal obligation had been established.

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SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. Currently, the Company has no plans to exit or dispose of any of its business activities that would require the use of SFAS No. 146 nor does it anticipate that SFAS No. 146 will change any of its business practices.

***g. Gains and Losses from Extinguishment of Debt and Capital Leases***

In April 2002, the FASB issued SFAS No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, to be applied in fiscal years beginning after May 15, 2002.

Under SFAS No. 145, gains and losses from extinguishment of debt should be classified as extraordinary items only if they meet the criteria of Accounting Principles Board Opinion ( APB ) No. 30. Under APB No. 30, events are considered extraordinary only if they possess a high degree of abnormality and are not likely to recur in the foreseeable future.

In February 2003, the Company redeemed the remaining principal amount outstanding of its 15.5% senior notes. This voluntary repayment resulted in the recognition of a loss on the early extinguishment of debt of \$7.4 million. The Company does not believe the loss meets the criteria of APB No. 30 as it has historically and may continue to change its capital structure to take advantage of current market conditions. As a result of adopting SFAS No. 145 on January 1, 2003, the Company recorded the debt retirement costs as a component of income from recurring operations.

SFAS No. 145 also amends SFAS No. 13, *Accounting for Leases*. Under SFAS No. 145, if a capital lease is modified such that it becomes an operating lease, a gain or loss must be recognized similar to the accounting used for sale-leaseback transactions as provided in SFAS No. 28 and No. 98. At June 30, 2003, the Company had capital lease obligations of \$454,000; however, the Company currently has no plans to modify these or any future capital leases.

***h. Asset Retirement Obligations***

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Company adopted SFAS No. 143 on January 1, 2003 without a material impact on its financial statements.

**Table of Contents****(10) Stock-Based Compensation**

The Company has granted stock options to various employees and accounts for these options under APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Under this method, when options are issued with a strike price equal to or greater than the market price on the date of issuance, there is no impact on earnings either on the date of issuance or thereafter regardless of strike price. This method is not a fair-value-based method of accounting as defined by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure, and Amendment of FASB Statement No. 123*. Fair-value-based methods of accounting require compensation expense to be recognized annually equal to the fair value of the options granted divided by their vesting period. Had the Company accounted for their stock options under SFAS No. 148 and the fair-value-based method of accounting, the Company's net income and earnings per share on a pro forma basis would be as indicated below (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
As reported	\$ 15,350	\$ 10,495	\$ 20,533	\$ 16,130
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(215)	(23)	(428)	(37)
Pro forma net income available to common stockholders	\$ 15,135	\$ 10,472	\$ 20,105	\$ 16,093
Earnings per common share:				
Basic - as reported	\$ 0.38	\$ 0.29	\$ 0.52	\$ 0.44
Basic - pro forma	\$ 0.37	\$ 0.29	\$ 0.50	\$ 0.44
Diluted - as reported	\$ 0.37	\$ 0.28	\$ 0.51	\$ 0.43
Diluted - pro forma	\$ 0.37	\$ 0.28	\$ 0.50	\$ 0.43

**(11) Commitments and Contingencies****a. State Laws**

The laws of many states prohibit business corporations from providing, or holding themselves out as providers of, veterinary medical care. These laws vary from state to state and are enforced by the courts and by regulatory authorities with broad discretion. The Company operates 64 animal hospitals in 11 states with these laws. The Company may experience difficulty in expanding operations into other states with similar laws. Given varying and uncertain interpretations of the veterinary laws of each state, the Company may not be in compliance with restrictions on the corporate practice of veterinary medicine in all states. A determination that the Company is in violation of applicable restrictions on the practice of veterinary medicine in any state in which it operates could have a material adverse effect, particularly if the Company were unable to restructure its operations to comply with the requirements of that state.

All of the states in which the Company operates impose various registration requirements. To fulfill these requirements, each facility has been registered with appropriate governmental agencies and, where required, has appointed a licensed veterinarian to act on behalf of each facility. All veterinarians practicing in the Company's clinics are required to maintain valid state licenses to practice.

**b. Other Contingencies**

The Company has certain contingent liabilities resulting from litigation and claims incident to the ordinary course of its business. Management believes that the probable resolution of such contingencies will not significantly affect the Company's financial position or results of operations.

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On November 30, 2001, two majority stockholders of a company that merged with Zoasis Corporation ( Zoasis ) in June 2000 filed a civil complaint against VCA, Zoasis and Robert Antin. Robert Antin, VCA's Chief Executive Officer, President and Chairman of the Board, is the majority stockholder of Zoasis and serves on its Board of Directors. The complaint alleges various tort claims under California law arising from the plaintiffs' investment in Zoasis. Zoasis filed a counter claim alleging breach of contract and claim and delivery. On March 25, 2003, the parties settled all claims in the litigation and executed a Settlement Agreement, Mutual Release and Covenant Not to Sue. Under the terms of the settlement, the parties dismissed their claims in the litigation with prejudice on April 17, 2003, and VCA paid plaintiffs \$2.0 million. Concurrent with the settlement, plaintiffs surrendered all of their Zoasis common stock. The \$2.0 million settlement and other related legal fees were fully accrued at December 31, 2002.

**(12) Reclassifications**

Certain 2002 balances have been reclassified to conform to the 2003 financial statement presentation.

**(13) Subsequent Events**

From July 1, 2003 through August 11, 2003, the Company acquired one animal hospital and one veterinary diagnostic laboratory, which was merged into an existing laboratory upon acquisition. Including acquisition costs, the Company paid an aggregate consideration of \$3.6 million, consisting of \$2.9 million in cash and \$770,000 in certain obligations to sellers and other liabilities assumed.

**(14) Condensed, Consolidating Information**

The Company has a legal structure comprised of a holding company and an operating company. VCA is the holding company. Vicar Operating, Inc. ( Vicar ) is the operating company and wholly-owned by VCA. Vicar owns the capital stock of all of the Company's subsidiaries.

In connection with Vicar's issuance in November 2001 of \$170.0 million of 9.875% senior subordinated notes, VCA and each existing and future domestic wholly-owned restricted subsidiary of Vicar (the Guarantor Subsidiaries ) have, jointly and severally, fully and unconditionally guaranteed the 9.875% senior subordinated notes. These guarantors are unsecured and subordinated in right of payment to all existing and future indebtedness outstanding under the Credit and Guaranty Agreement dated September 20, 2000 and any other indebtedness permitted to be incurred by Vicar under the terms of the indenture agreement for the 9.875% senior subordinated notes.

Vicar's subsidiaries are composed of wholly-owned restricted subsidiaries and partnerships. The partnerships may elect to serve as guarantors of Vicar's obligations, however, none of the partnerships have elected to do so (the Non-Guarantor Subsidiaries ). Vicar conducts all of its business through and derives virtually all of its income from its subsidiaries. Therefore, Vicar's ability to make required payments with respect to its indebtedness (including the 9.875% senior subordinated notes) and other obligations depends on the financial results and condition of its subsidiaries and its ability to receive funds from its subsidiaries.

Pursuant to Rule 3-10 of Regulation S-X, the following condensed, consolidating information is for VCA, Vicar, the Guarantor Subsidiaries and the Non-Guarantor Subsidiaries with respect to the 9.875% senior subordinated notes. This condensed financial information has been prepared from the books and records maintained by VCA, Vicar, the Guarantor Subsidiaries and the Non-Guarantor Subsidiaries. The condensed financial information may not necessarily be indicative of results of operations or financial position had the Guarantor Subsidiaries and the Non-Guarantor Subsidiaries operated as independent entities. The separate financial statements of the Guarantor Subsidiaries are not presented because management has determined they would not be material to investors.

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATING BALANCE SHEETS**

As of June 30, 2003

(Unaudited)

(In thousands)

	VCA	Vicar	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Elimination	Consolidated
<b>Current assets:</b>						
Cash and cash equivalents	\$	\$ 20,355	\$ 1,977	\$ 180	\$	\$ 22,512
Trade accounts receivable, net		9	24,889	639		25,537
Inventory, prepaid expenses and other		2,180	5,925	488		8,593
Deferred income taxes		10,405				10,405
Prepaid income taxes		2,704				2,704
	_____	_____	_____	_____	_____	_____
Total current assets		35,653	32,791	1,307		69,751
Property and equipment, net		7,056	88,231	1,558		96,845
Goodwill, net			342,439	20,790		363,229
Covenants not to compete, net			4,438	603		5,041
Deferred financing costs, net		5,952				5,952
Other	69	497	2,988	1,796	(915)	4,435
Investment in subsidiaries	180,231	277,747	21,901		(479,879)	
	_____	_____	_____	_____	_____	_____
Total assets	\$ 180,300	\$ 326,905	\$492,788	\$26,054	\$(480,794)	\$ 545,253
	_____	_____	_____	_____	_____	_____
<b>Current liabilities:</b>						
Current portion of long-term obligations	\$	\$ 1,743	\$ 955	\$	\$	\$ 2,698
Accounts payable		7,383	2,747			10,130
Accrued payroll and related liabilities		5,416	6,818	304		12,538
Accrued interest		1,493	40			1,533
Other accrued liabilities		12,146	6,199	95		18,440
	_____	_____	_____	_____	_____	_____
Total current liabilities		28,181	16,759	399		45,339
Long-term obligations, less current portion		335,021	1,686		(915)	335,792
Deferred income taxes		19,028				19,028
Other liabilities		2,007				2,007
Intercompany payable/(receivable)	42,351	(237,563)	196,596	(1,384)		
Minority interest					5,138	5,138
<b>Stockholders' equity:</b>						
Common stock	41					41
Additional paid-in capital	243,327					243,327
Notes receivable from stockholders	(95)					(95)
Accumulated equity (deficit)	(105,221)	180,334	277,747	27,039	(485,120)	(105,221)
Accumulated comprehensive loss - unrealized loss on hedging instruments	(103)	(103)			103	(103)
	_____	_____	_____	_____	_____	_____
Total stockholders' equity	137,949	180,231	277,747	27,039	(485,017)	137,949



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Total liabilities and stockholders equity	<u>          </u> \$ 180,300 <u>          </u>	<u>          </u> \$ 326,905 <u>          </u>	<u>          </u> \$492,788 <u>          </u>	<u>          </u> \$26,054 <u>          </u>	<u>          </u> \$(480,794) <u>          </u>	<u>          </u> \$ 545,253 <u>          </u>
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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATING BALANCE SHEETS**  
**As of December 31, 2002**  
**(In thousands)**

	VCA	Vicar	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Elimination	Consolidated
<b>Current assets:</b>						
Cash and cash equivalents	\$	\$ 5,083	\$ 1,233	\$ 146	\$	\$ 6,462
Trade accounts receivable, net		5	20,085	637		20,727
Inventory, prepaid expenses and other		2,684	5,414	545		8,643
Deferred income taxes		9,528				9,528
Prepaid income taxes		7,614				7,614
<b>Total current assets</b>		<b>24,914</b>	<b>26,732</b>	<b>1,328</b>		<b>52,974</b>
Property and equipment, net		6,727	86,077	2,499		95,303
Goodwill, net			321,887	20,727		342,614
Covenants not to compete, net			4,098	637		4,735
Deferred financing costs, net	386	6,392				6,778
Other	139	447	2,679	1,759		5,024
Investment in subsidiaries	155,115	239,671	23,403		(418,189)	
<b>Total assets</b>	<b>\$ 155,640</b>	<b>\$ 278,151</b>	<b>\$464,876</b>	<b>\$26,950</b>	<b>\$(418,189)</b>	<b>\$ 507,428</b>
<b>Current liabilities:</b>						
Current portion of long-term obligations	\$	\$ 9,240	\$ 382	\$	\$	\$ 9,622
Accounts payable		6,706	3,517			10,223
Accrued payroll and related liabilities		7,068	7,339	327		14,734
Accrued interest		1,547	18			1,565
Other accrued liabilities		10,325	3,124	15		13,464
<b>Total current liabilities</b>		<b>34,886</b>	<b>14,380</b>	<b>342</b>		<b>49,608</b>
Long-term obligations, less current portion	35,145	335,895	895			371,935
Deferred income taxes		15,376				15,376
Other liabilities		2,007				2,007
Intercompany payable/(receivable)	57,409	(265,128)	209,930	(2,211)		
Minority interest					5,416	5,416
<b>Stockholders' equity:</b>						
Common stock	37					37
Additional paid-in capital	188,941					188,941
Accumulated equity (deficit)	(125,754)	155,115	239,671	28,819	(423,605)	(125,754)
Notes receivable from stockholders	(138)					(138)
<b>Total stockholders' equity</b>	<b>63,086</b>	<b>155,115</b>	<b>239,671</b>	<b>28,819</b>	<b>(423,605)</b>	<b>63,086</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 155,640</b>	<b>\$ 278,151</b>	<b>\$464,876</b>	<b>\$26,950</b>	<b>\$(418,189)</b>	<b>\$ 507,428</b>



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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATING STATEMENTS OF OPERATIONS**  
**For the Three Months Ended June 30, 2003**  
**(Unaudited)**  
**(In thousands)**

	VCA	Vicar	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Elimination	Consolidated
Revenue	\$	\$	\$ 123,295	\$ 9,317	\$ (249)	\$ 132,363
Direct costs			80,012	6,741	(249)	86,504
			43,283	2,576		45,859
Selling, general and administrative		3,774	4,930	386		9,090
Depreciation and amortization		394	2,941	162		3,497
Loss (gain) on sale of assets		(1)	79			78
Operating income (loss)		(4,167)	35,333	2,028		33,194
Interest expense, net	(5)	6,429	37	(43)		6,418
Other expense		131				131
Equity interest in income of subsidiaries	15,347	21,491	1,609		(38,447)	
Income before minority interest and provision for income taxes	15,352	10,764	36,905	2,071	(38,447)	26,645
Minority interest in income of subsidiaries					462	462
Income before provision for income taxes	15,352	10,764	36,905	2,071	(38,909)	26,183
Provision (benefit) for income taxes	2	(4,583)	15,414			10,833
Net income	\$ 15,350	\$ 15,347	\$ 21,491	\$ 2,071	\$ (38,909)	\$ 15,350

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATING STATEMENTS OF OPERATIONS**  
**For the Three Months Ended June 30, 2002**  
**(Unaudited)**  
**(In thousands)**

	VCA	Vicar	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Elimination	Consolidated
Revenue	\$	\$ 500	\$ 107,515	\$ 9,453	\$ (243)	\$ 117,225
Direct costs			70,507	6,740	(243)	77,004
		500	37,008	2,713		40,221
Selling, general and administrative		3,665	4,503	371		8,539
Depreciation and amortization		344	2,614	181		3,139
Operating income (loss)		(3,509)	29,891	2,161		28,543
Interest expense, net	2,386	7,956	32	(30)		10,344
Other income		(61)				(61)
Equity interest in income of subsidiaries	11,995	19,204	1,663		(32,862)	
Income before minority interest and provision for income taxes	9,609	7,800	31,522	2,191	(32,862)	18,260
Minority interest in income of subsidiaries					528	528
Income before provision for income taxes	9,609	7,800	31,522	2,191	(33,390)	17,732
Provision (benefit) for income taxes	(886)	(4,195)	12,318			7,237
Net income	\$ 10,495	\$ 11,995	\$ 19,204	\$ 2,191	\$(33,390)	\$ 10,495

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATING STATEMENTS OF OPERATIONS**  
**For the Six Months Ended June 30, 2003**  
**(Unaudited)**  
**(In thousands)**

	VCA	Vicar	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Elimination	Consolidated
Revenue	\$	\$	\$231,303	\$17,535	\$ (475)	\$248,363
Direct costs			153,870	12,860	(475)	166,255
			77,433	4,675		82,108
Selling, general and administrative		7,927	9,797	729		18,453
Depreciation and amortization		740	6,018	316		7,074
Gain on sale of assets		(1)	(159)			(160)
Operating income (loss)		(8,666)	61,777	3,630		56,741
Interest expense, net	526	12,893	66	(75)		13,410
Debt retirement costs	7,417					7,417
Other expense		258				258
Equity interest in income of subsidiaries	25,219	38,076	2,882		(66,177)	
Income before minority interest and provision for income taxes	17,276	16,259	64,593	3,705	(66,177)	35,656
Minority interest in income of subsidiaries					823	823
Income before provision for income taxes	17,276	16,259	64,593	3,705	(67,000)	34,833
Provision (benefit) for income taxes	(3,257)	(8,960)	26,517			14,300
Net income	\$20,533	\$25,219	\$ 38,076	\$ 3,705	\$(67,000)	\$ 20,533

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATING STATEMENTS OF OPERATIONS**  
**For the Six Months Ended June 30, 2002**  
**(Unaudited)**  
**(In thousands)**

	VCA	Vicar	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Elimination	Consolidated
Revenue	\$	\$ 1,000	\$203,941	\$17,414	\$ (435)	\$221,920
Direct costs			137,484	12,543	(435)	149,592
		1,000	66,457	4,871		72,328
Selling, general and administrative		7,100	9,384	677		17,161
Depreciation and amortization		674	5,279	349		6,302
Operating income (loss)		(6,774)	51,794	3,845		48,865
Interest expense, net	4,527	15,801	62	(57)		20,333
Other income		(154)				(154)
Equity interest in income of subsidiaries	18,750	31,731	2,972		(53,453)	
Income before minority interest and provision for income taxes	14,223	9,310	54,704	3,902	(53,453)	28,686
Minority interest in income of subsidiaries					930	930
Income before provision for income taxes	14,223	9,310	54,704	3,902	(54,383)	27,756
Provision (benefit) for income taxes	(1,907)	(9,440)	22,973			11,626
Net income	\$ 16,130	\$ 18,750	\$ 31,731	\$ 3,902	\$(54,383)	\$ 16,130

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATING STATEMENTS OF CASH FLOWS**  
**For the Six Months Ended June 30, 2003**  
**(Unaudited)**  
**(In thousands)**

	<u>VCA</u>	<u>Vicar</u>	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Elimination</u>	<u>Consolidated</u>
Cash flows from operating activities:						
Net income	\$ 20,533	\$ 25,219	\$ 38,076	\$ 3,705	\$(67,000)	\$ 20,533
Adjustments to reconcile net income to net cash provided by (used in) operating activities:						
Equity interest in earnings of subsidiaries	(25,219)	(38,076)	(2,882)		66,177	
Depreciation and amortization		740	6,018	316		7,074
Amortization of deferred financing costs and debt discount	14	442				456
Provision for uncollectible accounts			1,408	149		1,557
Debt retirement costs	7,417					7,417
Gain of sale of assets		(1)	(159)			(160)
Minority interest in income of subsidiaries					823	823
Distributions to minority interest partners		(797)				(797)
Increase in trade accounts receivable		(4)	(5,196)	(151)		(5,351)
Decrease (increase) in inventory, prepaid expenses and other assets	70	363	(322)	57		168
Increase (decrease) in accounts payable and other accrued liabilities		2,395	(1,132)	80		1,343
Decrease in accrued payroll and related liabilities		(1,652)	(521)	(23)		(2,196)
Increase (decrease) in accrued interest		(54)	22			(32)
Decrease in prepaid income taxes		4,910				4,910
Increase in deferred income taxes asset		(877)				(877)
Increase in deferred income taxes liability		3,652				3,652
Increase in intercompany payable/(receivable)	(15,011)	52,148	(33,038)	(4,099)		
Net cash provided by (used in) operating activities	<u>(12,196)</u>	<u>48,408</u>	<u>2,274</u>	<u>34</u>		<u>38,520</u>



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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATING STATEMENTS OF CASH FLOWS - (Continued)**

**For the Six Months Ended June 30, 2003**

**(Unaudited)**

**(In thousands)**

	VCA	Vicar	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Elimination	Consolidated
<b>Cash flows from investing activities:</b>						
Business acquisitions, net of cash acquired	\$	\$(19,926)	\$	\$	\$	\$(19,926)
Real estate acquired in connection with acquisitions		(589)				(589)
Property and equipment additions, net		(4,404)	(1,764)			(6,168)
Proceeds from sale of assets		348	7			355
Other	(4)	138	227			361
<b>Net cash used in investing activities</b>	<b>(4)</b>	<b>(24,433)</b>	<b>(1,530)</b>			<b>(25,967)</b>
<b>Cash flows from financing activities:</b>						
Repayment of long-term obligations, including redemption fees	(41,808)	(8,703)				(50,511)
Payment of financing costs	(382)					(382)
Proceeds from issuance of common stock under stock option plans	67					67
Proceeds from issuance of common stock	54,323					54,323
<b>Net cash provided by (used in) financing activities</b>	<b>12,200</b>	<b>(8,703)</b>				<b>3,497</b>
Increase in cash and cash equivalents		15,272	744	34		16,050
Cash and cash equivalents at beginning of period		5,083	1,233	146		6,462
Cash and cash equivalents at end of period	\$	\$ 20,355	\$ 1,977	\$ 180	\$	\$ 22,512

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATING STATEMENTS OF CASH FLOWS**  
**For the Six Months Ended June 30, 2002**  
**(Unaudited)**  
**(In thousands)**

	<u>VCA</u>	<u>Vicar</u>	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Elimination</u>	<u>Consolidated</u>
Cash flows from operating activities:						
Net income	\$ 16,130	\$ 18,750	\$ 31,731	\$ 3,902	\$(54,383)	\$ 16,130
Adjustments to reconcile net income to net cash provided by (used in) operating activities:						
Equity interest in earnings of subsidiaries	(18,750)	(31,731)	(2,972)		53,453	
Depreciation and amortization		674	5,279	349		6,302
Amortization of deferred financing costs and debt discount	313	534				847
Provision for uncollectible accounts			1,243	177		1,420
Interest paid in kind on 15.5% senior notes	4,645					4,645
Minority interest in income of subsidiaries					930	930
Distributions to minority interest partners		(805)				(805)
Increase in trade accounts receivable			(5,278)	(567)		(5,845)
Decrease (increase) in inventory, prepaid expenses and other assets		458	(829)	9		(362)
Increase (decrease) in accounts payable and other accrued liabilities		(703)	1,462	66		825
Increase (decrease) in accrued payroll and related liabilities		(518)	280			(238)
Increase (decrease) in accrued interest		(295)	25			(270)
Decrease in prepaid income taxes		2,782				2,782
Increase in income taxes payable		1,901				1,901
Increase in deferred income taxes asset		(946)				(946)
Increase in deferred income taxes liability		4,498				4,498
Increase in intercompany payable/(receivable)	(2,423)	38,035	(31,373)	(4,239)		
Net cash provided by (used in) operating activities	(85)	32,634	(432)	(303)		31,814

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**VCA ANTECH, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**CONDENSED, CONSOLIDATING STATEMENTS OF CASH FLOWS - (Continued)**

**For the Six Months Ended June 30, 2002**

**(Unaudited)**

**(In thousands)**

	<u>VCA</u>	<u>Vicar</u>	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Elimination</u>	<u>Consolidated</u>
Cash flows from investing activities:						
Business acquisitions, net of cash acquired	\$	\$ (9,997)	\$	\$	\$	\$ (9,997)
Property and equipment additions, net		(4,774)	(1,430)			(6,204)
Other	68		61			129
	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Net cash provided by (used in) investing activities	68	(14,771)	(1,369)			(16,072)
	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Cash flows from financing activities:						
Repayment of long-term obligations		(2,485)				(2,485)
Payment of deferred financing and recapitalization costs		(2,673)				(2,673)
Proceeds from issuance of common stock under stock option plans	17					17
	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Net cash provided by (used in) financing activities	17	(5,158)				(5,141)
	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Increase (decrease) in cash and cash equivalents		12,705	(1,801)	(303)		10,601
Cash and cash equivalents at beginning of period		3,467	3,260	376		7,103
	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
Cash and cash equivalents at end of period	\$	\$ 16,172	\$ 1,459	\$ 73	\$	\$ 17,704
	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion should be read in conjunction with our condensed, consolidated financial statements provided under Part I, Item 1 of this quarterly report on Form 10-Q. Certain statements contained herein may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve a number of risks, uncertainties and other factors that could cause actual results to differ materially, as discussed more fully herein.*

*The forward-looking information set forth in this quarterly report on Form 10-Q is as of August 11, 2003, and we undertake no duty to update this information. Shareholders and prospective investors can find information filed with the Securities and Exchange Commission after August 11, 2003 at our website at [www.vcaantech.com](http://www.vcaantech.com) or at the Securities and Exchange Commission's website at [www.sec.gov](http://www.sec.gov). More information about potential factors that could affect our business and financial results is included in the section entitled "Risk Factors."*

**Overview**

We are a leading animal health care services company and operate the largest networks of veterinary diagnostic laboratories and free-standing, full-service animal hospitals in the United States. Our network of veterinary diagnostic laboratories provides sophisticated testing and consulting services used by veterinarians in the detection, diagnosis, evaluation, monitoring, treatment and prevention of diseases and other conditions affecting animals. Our animal hospitals offer a full range of general medical and surgical services for companion animals. We treat diseases and injuries, offer pharmaceutical products and perform a variety of pet wellness programs, including routine vaccinations, health examinations, diagnostic testing, spaying, neutering and dental care.

Our company was formed in 1986 by Robert Antin, Arthur Antin and Neil Tauber, who have served since our inception as our Chief Executive Officer, Chief Operating Officer and Senior Vice President of Development, respectively. During the 1990s, we established a premier position in the veterinary diagnostic laboratory and animal hospital markets through both internal growth and acquisitions. By 1997, we achieved a critical mass, building a laboratory network of 12 laboratories servicing animal hospitals in most states and completing acquisitions for a total of 160 animal hospitals. At June 30, 2003, our laboratory network consisted of 23 laboratories serving all 50 states and our animal hospital network consisted of 238 animal hospitals in 34 states. We primarily focus on generating internal growth to increase revenue and profitability. In order to augment internal growth, we may selectively acquire laboratories and intend to acquire approximately 15 to 25 animal hospitals per year, depending upon the attractiveness of candidates and the strategic fit with our existing operations.

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The following table summarizes our growth in facilities for the periods presented:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
<b>Laboratories:</b>				
Beginning of period	20	16	19	16
Acquisitions and new facilities	5	2	6	2
Relocated into other labs operated by us	(2)		(2)	
End of period	23	18	23	18
<b>Animal hospitals:</b>				
Beginning of period	233	216	229	214
Acquisitions	11	8	16	11
Relocated into other hospitals operated by us	(5)	(4)	(5)	(5)
Sold or closed	(1)		(2)	
End of period	238	220	238	220
Owned at end of period	174	163	174	163
Managed at end of period	64	57	64	57

**Basis of Reporting***General*

Our discussion and analysis of our financial condition and results of operations are based upon our condensed, consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States, or GAAP. We report our operations in three segments: laboratory, animal hospital and corporate. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expense, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

*Revenue Recognition*

We recognize revenue only after the following criteria are met:

there exists adequate evidence of the transaction;

delivery of goods has occurred or services have been rendered; and

the price is not contingent on future activity and collectibility is reasonably assured.

We report our revenue net of discounts.

*Laboratory Revenue*

A portion of laboratory revenue is intercompany revenue that was generated by providing laboratory services to our animal hospitals. Laboratory internal revenue growth for the three and six months ended June 30, 2003 was calculated using laboratory revenue as reported, adjusted to exclude revenue for the newly acquired laboratories that we did not own for the entire period presented and adjusted to exclude the impact resulting from differences in the number of billing days in comparable periods.



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Laboratory revenue is presented net of discounts. Some discounts, such as those given to clients for prompt payment, are applied to clients accounts in periods subsequent to the period the revenue was recognized. These discounts are estimated and deducted from revenue in the period the related revenue was recognized. These estimates are based upon historical experience. Errors in estimates would not have a material effect on our financial statements.

### ***Animal Hospital Revenue***

Animal hospital revenue is comprised of revenue of the animal hospitals that we own and the management fees for animal hospitals that we manage. Certain states prohibit business corporations from providing, or holding themselves out as providers of, veterinary medical care. In these states, we provide administrative and support services to veterinary medical groups pursuant to management agreements. The veterinary medical groups are each solely responsible for all aspects of the practice of veterinary medicine. In return for our services, the veterinary medical group pays us a management fee. We do not consolidate the operations of animal hospitals that we manage.

However, we believe that investors' understanding of the performance of our animal hospitals is enhanced by disclosing combined animal hospital revenue and animal hospital adjusted same-facility revenue, both of which include the revenue of the animal hospitals that we manage and exclude the management fees charged to those same animal hospitals. Management uses these non-GAAP financial measures to aid in its understanding of how all animal hospitals owned and managed are performing as a group.

There are material limitations associated with the use of these non-GAAP financial measures, as they are not reflective of the consolidated results for animal hospitals owned and managed as reported in our consolidated financial statements. To compensate for these limitations, we ensure that our disclosures provide a complete understanding of all adjustments found in non-GAAP financial measures, and we provide a reconciliation between the GAAP financial measures and the non-GAAP financial measures in *Results of Operations*.

Same-facility revenue growth based on GAAP and adjusted same-facility revenue growth include revenue generated by customers referred from our relocated or combined animal hospitals, including those combined upon acquisition.

### ***Other Revenue***

We recorded consulting fees from Heinz Pet Products relating to the marketing of its proprietary pet food. As of September 2002, the consulting agreement with Heinz Pet Products had expired.

### ***Direct Costs***

Laboratory direct costs are comprised of all costs of laboratory services, including salaries of veterinarians, specialists, technicians and other non-administrative, laboratory-based personnel, facilities rent, occupancy costs and supply costs. Animal hospital direct costs are comprised of all costs of services and products at the hospitals, including salaries of veterinarians, technicians and all other hospital-based personnel employed by the hospitals we own, facilities rent, occupancy costs, supply costs, certain marketing and promotional expense and costs of goods sold associated with the retail sales of pet food and pet supplies. Direct costs do not include salaries of veterinarians, technicians and certain other hospital-based personnel employed by the hospitals we manage. As a result, our direct costs are lower as a percentage of revenue than if we had consolidated the operating results of the animal hospitals we manage into our operating results.

However, we believe that the investors' understanding of our performance is enhanced by disclosing the combined direct costs of animal hospitals owned and managed for the entire periods presented. Management uses this non-GAAP financial measure to aid in its understanding of how all animal hospitals owned and managed are performing as a group.

There are material limitations associated with the use of this non-GAAP financial measure, as it is not reflective of the consolidated results for animal hospitals owned and managed as reported in our consolidated financial statements. To compensate for this limitation, we ensure that our disclosures provide a complete

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understanding of all adjustments found in non-GAAP financial measures, and we provide a reconciliation between the GAAP financial measures and the non-GAAP financial measures in *Results of Operations*.

***Selling, General and Administrative Expense***

Our selling, general and administrative expense is divided between our laboratory, animal hospital and corporate segments. Laboratory selling, general and administrative expense consists primarily of sales and administrative and accounting personnel and selling, marketing and promotional expense. Animal hospital selling, general and administrative expense consists primarily of field management, certain administrative and accounting personnel, recruiting and certain marketing expense. Corporate selling, general and administrative expense consists of administrative expense at our headquarters, including the salaries of corporate officers, rent, accounting, finance, legal and other professional expense and occupancy costs.

***Software Development Costs***

We frequently research, develop and implement new software to be used internally, or enhance our existing internal software. We develop the software using our own employees and/or outside consultants. Costs associated with the development of new software are expensed as incurred, particularly in the preliminary planning stages and the post-implementation and training stages. Costs related directly to the software design, coding, testing and installation are capitalized and amortized over the expected life of the software, generally three to five years. Costs related to upgrades or enhancements of existing systems are capitalized if the modifications result in additional functionality.

**Critical Accounting Policies and Significant Estimates**

Management is required to make critical accounting estimates that directly impact our consolidated financial statements and related disclosures. Critical accounting estimates are estimates that meet two criteria: (1) the estimates require that we make assumptions about matters that are highly uncertain at the time the estimates are made; and (2) there exist different estimates that could reasonably be used in the current period, or changes in the estimates used are reasonably likely to occur from period to period, both of which would have a material impact on the presentation of the financial condition or our results of our operations. Management bases its assumptions and estimates on historical experience and on various other factors believed to be reasonable under the circumstances. The following represent what management believes are the critical accounting policies most affected by significant management estimates and judgments. Management has discussed these critical accounting policies, the basis for their underlying assumptions and estimates and the nature of our related disclosures herein with our audit committee.

***Workers Compensation Expense***

Workers compensation expense is the cost to insure our company against losses related to injuries incurred by our employees in the normal course of their duties. Our workers compensation insurance policies are self-insurance retention programs, which mean that we bear the significant portion of the financial risk associated with claims losses, while the insurance company bears only the financial risk of large individual losses and large aggregate losses.

As a result of utilizing self-insurance retention policies, we must estimate the amount that we will ultimately pay for losses associated with workers compensation claims, or claims losses for the policy period. These estimated claims losses must be recorded as expense during the policy period. Claims losses can vary substantially and, because they can take years to develop fully, can be difficult to estimate. These estimates are based on complex judgments regarding the probable number of claims that will be filed and the nature of those claims. Both of those variables are highly uncertain and combine to form a factor referred to as the loss pick. The loss pick factor is multiplied by our payroll cost to determine what the projected costs for claims and our related expense will be.

We estimate the loss pick by reviewing a minimum of five years of our historical claims loss data and analyzing the trend of the development of claims over time. We also review and adjust the loss pick for other major factors such as the risk control environment and claims handling. The risk control environment includes proper safety training, safe working environment, availability of safety equipment for specific tasks, and management



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emphasis and monitoring of safe practices. Claims handling includes proper reporting of claims, proper care given to injured employees, availability of return-to-work programs, and oversight of the claims process by both the insurance claims handler and our own management. We review our loss pick on a quarterly basis considering the current loss trend and any changes in the environment as indicated above. The loss pick is then applied to our actual payroll costs to estimate the claims loss portion of our workers' compensation expense for the given period.

Our insurance carrier required us to pre-fund claims losses at a loss pick of 1.54% for the policy year ending September 30, 2002 and gave us a maximum loss pick of 2.49%, above which the carrier is responsible for paying all claims. For the policy year ending September 30, 2003, we are required to pre-fund claims losses at a loss pick of 1.59% and have a maximum loss pick of 2.55%. The ranges set forth by the insurance carrier reflect the most probable potentials for our workers' compensation claims losses. The increase in the insurance carriers' range reflects the trend over the last several years toward increasing workers' compensation costs. Based on these ranges and the factors described above, we chose a loss pick of 2.04% for the policy year ended September 30, 2002 and 2.00% for the policy year ending September 30, 2003. The decrease in our loss pick reflects the implementation of programs to reduce the risks in our operating environment and the improving trends in our historical claims losses.

The following table reflects the ranges for the loss picks and the loss picks used by us in the estimate of our workers' compensation costs (in thousands):

	Estimated Payroll	Expense Recorded	Probable Expense Range	
			Low-end	High-end
<b>Policy year ended September 30, 2002:</b>				
Loss pick percentage		2.04%	1.54%	2.49%
Calculated loss pick in dollars	\$ 169,022	\$ 3,441	\$ 2,603	\$ 4,208
Premiums and other fees		1,387	1,353	1,419
Total workers' compensation expense		\$ 4,828	\$ 3,956	\$ 5,627
<b>Policy year ending September 30, 2003 (9 months of a 12-month policy):</b>				
Loss pick percentage		2.00%	1.59%	2.55%
Calculated loss pick in dollars	\$ 135,972	\$ 2,719	\$ 2,162	\$ 3,467
Premiums and other fees		1,190	1,166	1,220
Total workers' compensation expense		\$ 3,909	\$ 3,328	\$ 4,687

We recognize workers' compensation expense in direct costs and selling, general and administrative expense of our segments, based on their respective payroll cost and the loss pick percentage discussed and shown above, to calculate the claims loss portion of the expense. The difference between the minimum amount of claims losses pre-funded to the insurance carrier and the amount expensed is accrued and included in other liabilities. If our estimates prove to be incorrect as the losses develop over several years, we will either have to pay additional claims losses or will receive a refund from our insurance carrier. This could result in a need for us to recognize additional expense or have expense reduced in future periods within the range shown above.

The insurance policies in place for 2000 and prior years did not have large deductibles and we have accrued for the maximum possible expense under these policies.

**Impairment of Goodwill**

Our goodwill represents the purchase price paid and liabilities assumed for animal hospital and laboratory acquisitions in excess of the fair market value of the net tangible assets acquired. The total amount of our net goodwill at June 30, 2003 was \$363.2 million, consisting of \$93.6 million for our laboratory operating segment and \$269.6 million for our animal hospital operating segment.



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We estimate annually the fair market value of our laboratory and animal hospital operating segments and compare that estimated fair market value against the net book value of those operating segments, as reflected in our financial statements, to determine if our goodwill is fairly stated or if its value is impaired. At December 31, 2002, we estimated the fair value of each of our operating segments and determined that the estimated fair value of each exceeded their respective net book value, resulting in a conclusion that our goodwill was fairly stated. For the period from December 31, 2002 through the date of this filing, there have been no significant changes in the operating environment of our operating segments or in the other variables used in our estimate of fair value that would cause us to believe that the fair value of our operating segments might have materially changed since our evaluation at December 31, 2002. We will review our goodwill for impairment again at December 31, 2003 or upon material changes in our operating environment. We do not anticipate that there will be significant changes in our operations or operating environments in the near future other than those related to possible acquisitions.

***Legal Settlements***

We are a party to various legal proceedings. Although we cannot determine the ultimate disposition of these proceedings, we can use judgment to reasonably estimate our liability for legal settlement costs that may arise as a result of these proceedings. Based on our prior experience, the nature of the current proceedings and our insurance policy coverage for such matters, we have accrued \$1.9 million as of June 30, 2003 for legal settlements as part of other accrued liabilities. We believe that our present insurance coverage and reserves are sufficient to cover currently known claims, but we cannot assure you that we will not incur liabilities in excess of recorded reserves.

***Allowance for Uncollectible Accounts***

Provision for uncollectible accounts is estimated based primarily upon age of accounts receivable and loss history. Accounts receivable balances are routinely reviewed in conjunction with collection efforts, historical collection rates and other economic conditions which might ultimately affect the collectibility of accounts when considering the adequacy of the amounts recorded as allowance for uncollectible accounts. Significant changes in client mix or economic conditions could affect our collection of accounts receivable, cash flows and results of operations.

***Income Taxes***

We make estimates in recording our provision for income taxes, including our determination of deferred income taxes assets, deferred income taxes liabilities and any valuation allowance against a deferred income taxes asset.

We operate in multiple states with varying tax laws. Our Federal income tax returns have been examined by the Internal Revenue Service through our fiscal year 1998, which resulted in no adjustment to our financial statements.

**Table of Contents****Results of Operations**

The following table sets forth components of our statements of operations data expressed as a percentage of revenue for the indicated periods:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
<b>Revenue:</b>				
Laboratory	35.3%	34.6%	35.6%	35.3%
Animal hospital	66.8	67.1	66.5	66.4
Other		0.4		0.4
Intercompany	(2.1)	(2.1)	(2.1)	(2.1)
<b>Total revenue</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Direct costs (excluding operating depreciation)	65.4	65.7	66.9	67.4
Selling, general and administrative	6.9	7.3	7.4	7.7
Depreciation and amortization	2.6	2.7	2.9	2.9
<b>Operating income</b>	<b>25.1</b>	<b>24.3</b>	<b>22.8</b>	<b>22.0</b>
Interest expense, net	4.9	8.8	5.4	9.2
Debt retirement costs			3.0	
Other (income) expense	0.1	(0.1)	0.1	(0.1)
Minority interest in income of subsidiaries	0.3	0.4	0.3	0.4
Provision for income taxes	8.2	6.2	5.7	5.2
<b>Net income</b>	<b>11.6%</b>	<b>9.0%</b>	<b>8.3%</b>	<b>7.3%</b>

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The following table is a summary of the components of operating income by segment (in thousands):

	<u>Laboratory</u>	<u>Animal Hospital</u>	<u>Corporate</u>	<u>Inter- company Eliminations</u>	<u>Total</u>
<b>Three Months Ended June 30, 2003</b>					
Revenue	\$46,691	\$ 88,424	\$	\$(2,752)	\$132,363
Direct costs (excluding operating depreciation)	24,816	64,440		(2,752)	86,504
Selling, general and administrative	2,797	2,519	3,774		9,090
Loss (gain) on sale of assets	21	58	(1)		78
Depreciation and amortization	799	2,304	394		3,497
Operating income (loss)	<u>\$18,258</u>	<u>\$ 19,103</u>	<u>\$(4,167)</u>	<u>\$</u>	<u>\$ 33,194</u>
Operating margin	<u>39.1%</u>	<u>21.6%</u>	<u>(3.1)%</u>		<u>25.1%</u>
<b>Three Months Ended June 30, 2002</b>					
Revenue	\$40,604	\$ 78,621	\$ 500	\$(2,500)	\$117,225
Direct costs (excluding operating depreciation)	22,134	57,370		(2,500)	77,004
Selling, general and administrative	2,396	2,478	3,665		8,539
Depreciation and amortization	726	2,069	344		3,139
Operating income (loss)	<u>\$15,348</u>	<u>\$ 16,704</u>	<u>\$(3,509)</u>	<u>\$</u>	<u>\$ 28,543</u>
Operating margin	<u>37.8%</u>	<u>21.2%</u>	<u>(3.0)%</u>		<u>24.3%</u>
<b>Six Months Ended June 30, 2003</b>					
Revenue	\$88,389	\$165,152	\$	\$(5,178)	\$248,363
Direct costs (excluding operating depreciation)	48,272	123,161		(5,178)	166,255
Selling, general and administrative	5,504	5,022	7,927		18,453
Loss (gain) on sale of assets	19	(178)	(1)		(160)
Depreciation and amortization	1,553	4,781	740		7,074
Operating income (loss)	<u>\$33,041</u>	<u>\$ 32,366</u>	<u>\$(8,666)</u>	<u>\$</u>	<u>\$ 56,741</u>
Operating margin	<u>37.4%</u>	<u>19.6%</u>	<u>(3.5)%</u>		<u>22.8%</u>
<b>Six Months Ended June 30, 2002</b>					
Revenue	\$78,261	\$147,265	\$ 1,000	\$(4,606)	\$221,920
Direct costs (excluding operating depreciation)	43,696	110,502		(4,606)	149,592
Selling, general and administrative	5,069	4,992	7,100		17,161
Depreciation and amortization	1,423	4,205	674		6,302
Operating income (loss)	<u>\$28,073</u>	<u>\$ 27,566</u>	<u>\$(6,774)</u>	<u>\$</u>	<u>\$ 48,865</u>
Operating margin	<u>35.9%</u>	<u>18.7%</u>	<u>(3.1)%</u>		<u>22.0%</u>



**Table of Contents****Revenue**

The following table summarizes our revenue (in thousands):

	Three Months Ended June 30,			Six Months Ended June 30,		
	2003	2002	% Change	2003	2002	% Change
Laboratory	\$ 46,691	\$ 40,604	15.0%	\$ 88,389	\$ 78,261	12.9%
Animal hospital	88,424	78,621	12.5%	165,152	147,265	12.1%
Other		500			1,000	
Intercompany	(2,752)	(2,500)		(5,178)	(4,606)	
<b>Total revenue</b>	<b>\$ 132,363</b>	<b>\$ 117,225</b>	<b>12.9%</b>	<b>\$ 248,363</b>	<b>\$ 221,920</b>	<b>11.9%</b>

**Laboratory Revenue**

Laboratory revenue increased \$6.1 million for the three months ended June 30, 2003 and increased \$10.1 million for the six months ended June 30, 2003 compared to the same periods in the prior year. The components of the increase in laboratory revenue are detailed below (in thousands, except average price per requisition):

Laboratory Revenue:	Three Months Ended June 30,			Six Months Ended June 30,		
	2003	2002	% Change	2003	2002	% Change
Internal growth:						
Number of requisitions	2,169	2,064	5.1%	4,005	3,840	4.3%
Average revenue per requisition (1)	\$ 21.02	\$ 19.67	6.9%	\$ 21.73	\$ 20.25	7.3%
Total internal revenue (2)	\$45,583	\$40,604	12.3%	\$87,031	\$77,753	11.9%
Billing day adjustment					508	
Acquired revenue	1,108			1,358		
<b>Total</b>	<b>\$46,691</b>	<b>\$40,604</b>	<b>15.0%</b>	<b>\$88,389</b>	<b>\$78,261</b>	<b>12.9%</b>

(1) Computed by dividing total internal revenue by the number of requisitions.

(2) Numbers may not calculate exactly due to rounding.

Laboratory revenue and requisitions generated from internal growth, as referred to in the above table, have been adjusted to exclude revenue and requisitions for newly acquired laboratories (those laboratories that we did not own for the entire periods presented) and have been adjusted for differences in the number of billing days in comparable periods.

The increase in requisitions from internal growth during the three and six months ended June 30, 2003 is the result of a trend in veterinary medicine to focus on the importance of laboratory diagnostic testing in the diagnosis and treatment of diseases. In addition, our marketing programs include comprehensive education to our veterinarian clients, which have contributed to the growth in our revenue in both volume and breadth of tests performed.

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The increase in the average revenue per requisition during the three and six months ended June 30, 2003 is attributable to our sales and marketing efforts of our pet health and wellness programs, which have contributed to an increase in the number of tests performed per requisition, as well as a change in the mix of tests to more comprehensive and expensive tests. Also contributing to our increase in average revenue per requisition are price increases. The prices of most tests were increased 4% to 5% in February 2003.

As the result of acquiring seven laboratories between November 2002 and June 2003, we generated an additional \$1.1 million of revenue (referred to in the above table as acquired revenue ) during the three months ended June 30, 2003 and \$1.4 million of revenue during the six months ended June 30, 2003 compared to the same periods in the prior year.



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The billing day adjustment, referred to in the above table, reflects the impact of one more billing day for the six months ended June 30, 2002 compared to the current period.

*Animal Hospital Revenue*

The following table reconciles our animal hospital revenue, as reported under GAAP, to the combined revenue of animal hospitals that we owned and managed, referred to as combined animal hospital revenue, as if we had consolidated the operating results of the animal hospitals we managed into our operating results (in thousands):

Animal Hospital Revenue:	Three Months Ended June 30,			Six Months Ended June 30,		
	2003	2002	% Change	2003	2002	% Change
As reported	\$ 88,424	\$ 78,621	12.5%	\$ 165,152	\$ 147,265	12.1%
Less: Management fees (1)	(13,656)	(12,488)		(24,600)	(22,193)	
Add: Revenue of animal hospitals managed	24,054	21,940		44,577	40,255	
Combined animal hospital (2)	\$ 98,822	\$ 88,073	12.2%	\$ 185,129	\$ 165,327	12.0%

(1) Paid to us by veterinary medical groups.

(2) Represents the combined animal hospital revenue of hospitals owned and managed.

The combined animal hospital revenue increased \$10.7 million for the three months ended June 30, 2003 and increased \$19.8 million for the six months ended June 30, 2003 compared to the same periods in the prior year. The components of the increase are summarized in the following table (in thousands, except average price per order):

Animal Hospital Revenue:	Three Months Ended June 30,			Six Months Ended June 30,		
	2003	2002	% Change	2003	2002	% Change
Adjusted same-facility:						
Orders (1)	842	854	(1.4)%	1,584	1,613	(1.8)%
Average price per order (2)	\$ 106.26	\$ 101.78	4.4%	\$ 106.10	\$ 101.10	4.9%
Adjusted same-facility revenue (1)						
(3)	\$ 89,467	\$ 86,924	2.9%	\$ 168,055	\$ 163,072	3.1%
Net acquired revenue (1)	9,355	1,149		17,074	2,255	
Combined animal hospital (4)	\$ 98,822	\$ 88,073		\$ 185,129	\$ 165,327	

(1) Adjusted same-facility revenue, orders and net acquired revenue are non-GAAP measures of combined animal hospitals owned and managed. These non-GAAP measures are reconciled to the GAAP measures in tables below.

(2) Computed by dividing adjusted same-facility revenue by adjusted same-facility orders.

(3) Numbers may not calculate exactly due to rounding.

(4) Represents the combined animal hospital revenue of hospitals owned and managed.

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Our animal hospital segment has placed a greater emphasis on providing high-quality veterinary care and comprehensive wellness programs, which has contributed to the increase in the average price per order and the increase in adjusted same-facility revenue for the three and six months ended June 30, 2003. The decrease in the number of orders for the current quarter is partly related to a decrease in the number of orders for sales of vaccines. Additionally, sales of flea and other over-the-counter products have decreased as a result of changes in the channels of distribution for these products.

Net acquired revenue for the three months ended June 30, 2003 and 2002 represents revenue from hospitals acquired, sold or closed on or subsequent to April 1, 2002. Net acquired revenue for the six months ended June 30, 2003 and 2002 represents revenue from hospitals acquired, sold or closed on or subsequent to January 1, 2002.

*Reconciliation Between Non-GAAP and GAAP Measures*

In the above tables, we use non-GAAP measures to reflect the combined performance of animal hospitals owned and managed. The tables below reconcile those non-GAAP measures to their comparable GAAP measures (in thousands):

	Three Months Ended June 30,			Six Months Ended June 30,		
	2003	2002	% Change	2003	2002	% Change
<b>Animal Hospital Revenue:</b>						
Adjusted same-facility revenue (1)	\$ 89,467	\$ 86,924	2.9%	\$ 168,055	\$ 163,072	3.1%
Same-facility revenue of animal hospitals managed	(21,482)	(21,592)		(39,743)	(39,610)	
Same-facility revenue of animal hospitals owned	67,985	65,332		128,312	123,462	
Same-facility management fees (2)	12,210	12,292		21,898	21,821	
Same-facility revenue	\$ 80,195	\$ 77,624	3.3%	\$ 150,210	\$ 145,283	3.4%

(1) Adjusted same-facility revenue is a non-GAAP measure of combined animal hospitals owned and managed.

(2) Paid to us by veterinary medical groups.

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The following table reconciles the non-GAAP measure of orders for combined animal hospitals owned and managed to the GAAP measure of orders for animal hospitals owned (in thousands, except average price per order):

	Three Months Ended June 30,		
	2003	2002	% Change
Same-facility:			
Orders for combined animal hospitals owned and managed	842	854	
Orders for animal hospitals managed	(207)	(217)	
Orders for animal hospitals owned	635	637	(0.3)%
Average price per order for animal hospitals owned (1)	\$ 107.06	\$ 102.56	4.4%
Same-facility revenue for animal hospitals owned (2)	\$67,985	\$65,332	4.1%
Same-facility management fees	12,210	12,292	
Acquired revenue and management fees from acquired managed practices	8,229	997	
Animal hospital revenue as reported	\$88,424	\$78,621	

	Six Months Ended June 30,		
	2003	2002	% Change
Same-facility:			
Orders for combined animal hospitals owned and managed	1,584	1,613	
Orders for animal hospitals managed	(386)	(404)	
Orders for animal hospitals owned	1,198	1,209	(0.9)%
Average price per order for animal hospitals owned (1)	\$ 107.11	\$ 102.12	4.9%
Same-facility revenue for animal hospitals owned (2)	\$ 128,312	\$ 123,462	3.9%
Same-facility management fees	21,898	21,821	
Acquired revenue and management fees from acquired managed practices	14,942	1,982	
Animal hospital revenue as reported	\$ 165,152	\$ 147,265	

- (1) Computed by dividing same-facility revenue for animal hospitals owned by same-facility orders for animal hospitals owned.  
(2) Numbers may not calculate exactly due to rounding.

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The following table reconciles the non-GAAP measure of acquired revenue for combined animal hospitals owned and managed to the GAAP measure of acquired revenue (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Acquired revenue for combined animal hospitals owned and managed	\$ 9,355	\$ 1,149	\$ 17,074	\$ 2,255
Less: acquired revenue for animal hospitals managed	(2,571)	(349)	(4,833)	(646)
Acquired revenue for animal hospitals owned	\$ 6,784	\$ 800	\$ 12,241	\$ 1,609

*Other Revenue*

Other revenue consists of fees earned from a marketing consulting agreement with Heinz Pet Products, which paid a monthly fee of approximately \$167,000 commencing October 1, 2000 through September 30, 2002. For the three and six months ended June 30, 2002, we recognized revenue of \$500,000 and \$1.0 million, respectively, related to this agreement. There were no consulting agreements effective in 2003.

*Direct Costs*

The following table summarizes our direct costs (excluding operating depreciation) and our direct costs (excluding operating depreciation) as a percentage of applicable revenue (in thousands):

	Three Months Ended June 30,					Six Months Ended June 30,				
	2003		2002		% Change	2003		2002		% Change
	\$	% of Revenue	\$	% of Revenue		\$	% of Revenue	\$	% of Revenue	
Laboratory	\$24,816	53.1%	\$22,134	54.5%	12.1%	\$ 48,272	54.6%	\$ 43,696	55.8%	10.5%
Animal hospital	64,440	72.9%	57,370	73.0%	12.3%	123,161	74.6%	110,502	75.0%	11.5%
Intercompany	(2,752)		(2,500)			(5,178)		(4,606)		
Total direct costs	\$86,504	65.4%	\$77,004	65.7%	12.3%	\$166,255	66.9%	\$149,592	67.4%	11.1%

*Laboratory Direct Costs*

The decrease in laboratory direct costs as a percentage of laboratory revenue was primarily attributable to an increase in laboratory revenue combined with operating leverage associated with our laboratory business. Our operating leverage comes from the incremental margins we realize on additional tests ordered by the same client, as well as when more comprehensive tests are ordered. We are able to benefit from these incremental margins due to the relative fixed cost nature of our laboratory business.

**Table of Contents***Animal Hospital Direct Costs*

The following table summarizes our animal hospital direct costs as reported and the combined direct costs of animal hospitals that we owned and managed, referred to as combined animal hospital direct costs, had we consolidated the operating results of the animal hospitals we manage into our operating results (in thousands):

Animal Hospital Direct Costs:	Three Months Ended June 30,				
	2003		2002		% Change
	\$	% of Revenue	\$	% of Revenue	
As reported	\$ 64,440	72.9%	\$ 57,370	73.0%	12.3%
Add: Direct costs of animal hospitals managed	24,054		21,940		
Less: Management fees (1)	(13,656)		(12,488)		
Combined animal hospital (2)	\$ 74,838	75.7%	\$ 66,822	75.9%	12.0%

Animal Hospital Direct Costs:	Six Months Ended June 30,				
	2003		2002		% Change
	\$	% of Revenue	\$	% of Revenue	
As reported	\$ 123,161	74.6%	\$ 110,502	75.0%	11.5%
Add: Direct costs of animal hospitals managed	44,577		40,255		
Less: Management fees (1)	(24,600)		(22,193)		
Combined animal hospital (2)	\$ 143,138	77.3%	\$ 128,564	77.8%	11.3%

(1) Charged by us to veterinary medical groups.

(2) Represents the combined animal hospital direct costs of hospitals owned and managed.

The decrease in combined animal hospital direct costs as a percentage of applicable revenue was attributable to the increase in the combined animal hospital revenue combined with the operating leverage associated with the animal hospital business, as most of the costs associated with this business do not increase proportionately with increases in the volume of services rendered.

*Selling, General and Administrative Expense*

The following table summarizes our selling, general and administrative expense, or SG&A, and our expense as a percentage of applicable revenue (in thousands):

Three Months Ended June 30,		Six Months Ended June 30,	
2003	2002	2003	2002

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	\$	% of Revenue	\$	% of Revenue	% Change	\$	% of Revenue	\$	% of Revenue	% Change
Laboratory	\$2,797	6.0%	\$2,396	5.9%	16.7%	\$ 5,504	6.2%	\$ 5,069	6.5%	8.6%
Animal hospital	2,519	2.8%	2,478	3.2%	1.7%	5,022	3.0%	4,992	3.4%	0.6%
Corporate	3,774	2.9%	3,665	3.1%	3.0%	7,927	3.2%	7,100	3.2%	11.6%
	\$9,090	6.9%	\$8,539	7.3%	6.5%	\$18,453	7.4%	\$17,161	7.7%	7.5%

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*Laboratory SG&A*

The increase in laboratory SG&A as a percentage of laboratory revenue during the three months ended June 30, 2003 as compared to the same period in the prior year was primarily attributable to additional information technology personnel and commission payments to sales representatives. The decrease in laboratory SG&A as a percentage of laboratory revenue during the six months ended June 30, 2003 as compared to the same periods in the prior year was primarily attributable to a decrease in legal costs offset by the same factors attributable to the increase during the three months ended June 30, 2003.

*Animal Hospital SG&A*

The decrease in animal hospital SG&A as a percentage of animal hospital revenue during the three and six months ended June 30, 2003 as compared to the same periods in the prior year was primarily attributable to an increase in animal hospital revenue combined with operating leverage associated with our animal hospital business.

*Corporate SG&A*

The decrease in corporate SG&A as a percentage of total revenue for the three months ended June 30, 2003 as compared to the same period in the prior year was primarily due to a decrease in accounting fees. Corporate SG&A for the three months ended June 30, 2002 included additional accounting fees incurred in connection with changing our external auditors from Arthur Andersen LLP to KPMG LLP. For the six months ended June 30, 2003 and 2002, corporate SG&A remained constant as a percentage of revenue but increased 11.6% for the six months ended June 30, 2003 compared to the same period in the prior year. This increase was primarily attributable to increased legal and insurance fees as well as increases in salaries and bonuses.

***Depreciation and Amortization***

Depreciation and amortization expense increased \$358,000, or 11.4%, for the three months ended June 30, 2003 and increased \$772,000, or 12.3%, for the six months ended June 30, 2003 compared to the same periods in the prior year. The increase in depreciation and amortization was due to the purchase of property and equipment and the addition of non-competition agreements executed in connection with the acquisition of animal hospitals and laboratories.

***Loss (Gain) on Sale of Assets***

During the three and six months ended June 30, 2003, we sold certain assets for a loss of \$78,000 and a gain of \$160,000, respectively. The sales transactions consisted of real estate, one animal hospital practice and other fixed assets.

***Interest Expense, Net***

Interest expense, net of interest income decreased \$3.9 million, or 38.0%, for the three months ended June 30, 2003 and decreased \$6.9 million, or 34.0%, for the six months ended June 30, 2003 compared to the same periods in the prior year. The change in net interest expense was attributable to a decrease in the average debt balances outstanding and a decrease in the weighted average interest rate.

***Debt Retirement Costs***

On February 4, 2003, we voluntarily retired the entire principal amount of our 15.5% senior notes with net proceeds from the sale of our common stock during our secondary offering. In conjunction with that transaction, we recorded debt retirement costs of \$7.4 million. The debt retirement costs consisted of the write-off of deferred financing costs and debt discounts and the payment of related transaction and retirement fees.

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***Other (Income) Expense***

Other expense was \$131,000 for the three months ended June 30, 2003 and \$258,000 for the six months ended June 30, 2003, consisting of a non-cash loss on the interest rate swap agreements. Other income was \$61,000 for the three months ended June 30, 2002 and \$154,000 for the six months ended June 30, 2002, consisting of a non-cash gain on the interest rate collar agreement.

***Minority Interest in Income of Subsidiaries***

Minority interest in income of the consolidated subsidiaries was \$462,000 and \$528,000 for the three months ended June 30, 2003 and 2002, respectively, and \$823,000 and \$930,000 for the six months ended June 30, 2003 and 2002, respectively. Minority interest in income of subsidiaries represents our partners' proportionate share of net income generated by those subsidiaries that we do not wholly own.

***Provision for Income Taxes***

Our effective income tax rate for each period can vary from the statutory rate primarily due to the non-deductibility for income tax purposes of certain items. During the three and six months ended June 30, 2003, our effective income tax rate varied from the statutory rate primarily due to the non-deductibility of the amortization of a portion of intangible assets.

**Liquidity and Capital Resources**

***Discussion of the Six Months Ended June 30, 2003***

Our cash and cash equivalents increased to \$22.5 million at June 30, 2003 compared to \$6.5 million at December 31, 2002. The increase resulted from \$38.5 million provided by operating activities and \$3.5 million provided by financing activities offset by \$26.0 million used in investing activities.

Net cash provided by operating activities increased to \$38.5 million during the six months ended June 30, 2003 compared to \$31.8 million during the six months ended June 30, 2002. This increase was primarily attributable to an increase in operating income and a \$2.2 million decrease in interest paid, offset by a \$3.2 million increase in income taxes paid.

We used net cash of \$26.0 million for investing activities during the six months ended June 30, 2003 in which we:

paid \$19.9 million related to the acquisition of 16 animal hospitals and six laboratories and the settlement of certain obligations incurred or agreed to on the date of acquisition;

paid \$589,000 for real estate acquired in connection with acquisitions;

paid \$6.2 million in property and equipment additions; and

received \$716,000 from the sale of assets and other activities.

We received net cash of \$3.5 million from financing activities during the six months ended June 30, 2003 in which we:

received \$54.3 million in net proceeds from the issuance of 3.8 million shares of our common stock;

paid \$41.8 million to voluntarily redeem the entire principal amount of our 15.5% senior notes at a redemption price of 110% of the principal amount;

paid \$1.2 million for scheduled maturities of debt obligations;



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repaid \$7.5 million, the entire outstanding balance, of our revolving credit facility; and

paid \$382,000 of financing costs.

***Future Cash Requirements***

We expect to fund our liquidity needs primarily from operating cash flows, cash on hand and, if needed, borrowings under our \$50.0 million revolving credit facility. At June 30, 2003, we had no borrowings outstanding under our revolving credit facility. We believe these sources of funds will be sufficient to continue our operations and planned capital expenditures and to satisfy our scheduled principal and interest payments under debt obligations for at least the next 12 months. However, a significant portion of our cash requirements will be determined by the pace and size of our acquisitions.

Estimated future uses of cash for the remainder of 2003 include capital expenditures for land, buildings and equipment of approximately \$11.8 million. In addition, we intend to use available liquidity to continue our growth through the selective acquisition of animal hospitals, primarily for cash. Our acquisition program contemplates the acquisition of 15 to 25 animal hospitals per year and a planned cash commitment of up to \$30.0 million. However, we may purchase either a fewer or greater number of animal hospital facilities and we may purchase laboratory facilities during any year depending upon opportunities that present themselves and our cash requirements may change accordingly. We anticipate purchasing up to 20 animal hospitals and seven laboratories with a planned cash commitment of \$31.9 million during 2003. Although we intend to primarily use cash in our acquisitions, we may use debt or stock to the extent we deem it appropriate.

In addition to the foregoing, we will use approximately \$1.3 million of cash for the remainder of 2003 to pay the mandatory principal payments due on our outstanding indebtedness. Also, we plan to pre-pay approximately \$20.0 million of our senior term C notes in the near future and we may elect to pre-pay additional debt obligations.

**Description of Indebtedness**

*Credit and Guaranty Agreement.* On September 20, 2000, we entered into a credit and guaranty agreement, which included senior term notes and a \$50.0 million revolving credit facility. At June 30, 2003, we had \$166.4 million principal amount outstanding under our senior term C notes and no borrowings outstanding under our revolving credit facility.

Borrowings under the credit and guaranty agreement bear interest, at our option, on either the base rate, which is the higher of the administrative agent's prime rate or the Federal funds rate plus 0.5%, or the adjusted eurodollar rate, which is the rate per annum obtained by dividing (1) the rate of interest offered to the administrative agent on the London interbank market by (2) a percentage equal to 100% minus the stated maximum rate of all reserve requirements applicable to any member bank of the Federal Reserve System in respect of eurocurrency liabilities. The base rate margins for the revolving credit facility range from 1.00% to 2.25% per annum and the margin for the senior term C notes is 2.00%. The eurodollar rate margins for the revolving credit facility range from 2.00% to 3.25% per annum and the margin for the senior term C notes is 3.00%.

The senior term C notes mature in September 2008 and the revolving credit facility matures in September 2006.

The credit and guaranty agreement contains certain financial covenants pertaining to interest coverage, fixed charge coverage and leverage ratios. In addition, the credit and guaranty agreement has restrictions pertaining to capital expenditures, acquisitions and the payment of dividends on all classes of stock. We currently believe the most restrictive covenant is the fixed-charge coverage ratio. Our credit agreement defines the fixed charge coverage ratio as that ratio which is calculated on a last twelve-month basis by dividing pro forma EBITDA, as defined by the agreement, by fixed charges. Fixed charges are defined as cash interest expense, scheduled principal payments on debt obligations, capital expenditures and provision for income taxes. At June 30, 2003, we had a fixed charge coverage ratio of 1.44 to 1.00. The credit and guaranty agreement requires a fixed-charge coverage ratio of no less than 1.10 to 1.00.

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*9.875% Senior Subordinated Notes.* On November 27, 2001, Vicar Operating, Inc., our wholly-owned subsidiary, issued \$170.0 million in principal amount of senior subordinated notes due December 1, 2009, which were exchanged on June 13, 2002 for substantially similar securities that are registered under the Securities Act. Interest on these senior subordinated notes is 9.875% per annum, payable semi-annually in arrears in cash. At June 30, 2003, the outstanding principal balance of these senior subordinated notes was \$170.0 million. We and each existing and future domestic wholly-owned subsidiary of Vicar have jointly and severally, fully and unconditionally guaranteed these notes. These guarantees are unsecured and subordinated in right of payment to all existing and future indebtedness outstanding under the credit and guaranty agreement and any other indebtedness permitted to be incurred by Vicar under the terms of the indenture agreement governing these notes.

*15.5% Senior Notes.* On February 4, 2003, we used approximately \$42.7 million of the net proceeds received from the sale of our common stock during our secondary offering to redeem the remaining principal amount outstanding of our 15.5% senior notes due 2010 at a redemption price of 110% of the principal amount, plus accrued and unpaid interest.

*Other Debt.* We had seller notes secured by assets of animal hospitals, unsecured debt and capital leases that totaled \$2.1 million at June 30, 2003.

*Contractual Obligations.* There have been no significant changes to our contractual obligations or commitments from those disclosed in our most recently filed Form 10-K.

**Interest Rate Hedging Agreements**

We entered into the following no-fee swap agreements, which swap monthly variable LIBOR for the fixed rates indicated below:

	Swap #1	Swap #2	Swap #3
Fixed interest rate	2.22%	1.72%	1.51%
Notional amount	\$40.0 million	\$20.0 million	\$20.0 million
Effective date	11/29/2002	5/30/2003	5/30/2003
Expiration date	11/29/2004	5/31/2005	5/31/2005
Counter party	Wells Fargo Bank	Wells Fargo Bank	Goldman Sachs

Swap # 2 and Swap #3 qualify for hedge accounting and we consider them to be cash flow hedging instruments. However, in May 2003 management determined that Swap #1 was no longer an effective tool to hedge against interest rate risk because LIBOR projections were considerably below the initial LIBOR forecasts used to price the swap at inception of the contract. As a result of this determination, Swap #1 no longer qualifies for hedge accounting and all changes in its market value are recognized as income or expense in the period of change.

At June 30, 2003, the fair market values of our swap agreements resulted in a net liability to us of \$674,000, which is included in other accrued liabilities. For the three and six months ended June 30, 2003, we made payments of \$102,000 and \$187,000, respectively, as a result of LIBOR being below the fixed interest rates. These payments are included in interest expense.

We are considering entering into additional interest rate strategies to take advantage of the current rate environment. We have not yet determined what those strategies will be or their possible impact.

**New Accounting Pronouncements***Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*

In May 2003, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. SFAS No. 150 clarifies the accounting for certain financial instruments with characteristics of both liabilities and equity and requires that those instruments be classified as liabilities. SFAS No.

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150 is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We currently have a \$2.3 million obligation to be settled in either cash or common stock that is classified as a liability; we do not have any immediate plans to enter into other financial instruments subject to the accounting requirements of SFAS No. 150. The adoption of SFAS No. 150 will not have a material impact on our financial statements.

### ***Accounting for Derivative Instruments and Hedging Activities***

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 clarifies financial accounting and reporting requirements for derivative instruments and hedging activities as set forth under SFAS No. 133. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships entered into after June 30, 2003. The adoption of SFAS No. 149 will not have a material impact on our financial statements.

### ***Consolidations of Variable Interest Entities***

In January 2003, the FASB issued FASB Interpretation, or FIN, No. 46, *Consolidation of Variable Interest Entities*, requiring that companies consolidate variable interest entities if they are the primary beneficiaries, as defined under FIN No. 46, of the activities of the variable interest entities. Companies are required to apply FIN No. 46 immediately for all variable interest entities created after January 31, 2003 and as of the beginning of the first interim period beginning after June 15, 2003 for all other variable interest entities.

We provide management services to certain veterinary medical groups in states with laws that prohibit business corporations from providing, or holding themselves out as providers of, veterinary medical care. As of June 30, 2003, we operated in 11 of these states. In these states, we provide management services to veterinary medical groups pursuant to long-term management agreements ranging from 10 to 40 years with non-binding renewal options, where allowable. Pursuant to the management agreements, the veterinary medical groups are each solely responsible for all aspects of the practice of veterinary medicine, as defined by their respective state. We provide administrative and other support services.

Currently, we do not consolidate the operations of the veterinary medical groups since we have no ownership interests in them. However, we are finalizing our analysis of FIN No. 46 and it is reasonably possible that the operations of the veterinary medical groups will be consolidated. If the veterinary medical groups were to be consolidated into our operating results, there would be no effect on operating income and we would not be exposed to additional losses. We would consolidate the revenue and direct costs of the veterinary medical groups but would not recognize the management fees charged to them. See our discussions regarding animal hospital revenue included herein in the *Revenue* section for full details regarding the veterinary medical groups.

### ***Guarantor s Accounting and Disclosure Requirements for Guarantees***

In January 2003, the FASB issued FIN No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN No. 45 requires a company to recognize a liability for the obligations it has undertaken in issuing a guarantee. This liability would be recorded at the inception of a guarantee and would be measured at fair value. The measurement provisions of this statement apply prospectively to guarantees issued or modified after December 31, 2002 for periods ending after December 15, 2002. We do not have any obligations subject to the provisions of FIN No. 45.

### ***Consideration Received from a Vendor***

In November 2002, FASB s Emerging Issues Task Force, or EITF, reached a consensus regarding two issues raised by EITF Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*. The EITF concluded that:

cash received by a vendor is presumed to be a reduction of the cost of the vendor s products or services, however that presumption is overcome when the consideration is either (a) a payment for

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assets or services, or b) a reimbursement of specific and identifiable costs incurred on behalf of the vendor in selling the vendor's products or services, in which case the consideration is a reduction of that cost; and

rebates offered to a customer or reseller should be recognized on new agreements entered into on or after January 1, 2003. We have adopted EITF Issue No. 02-16 and we do not expect it to have a material impact on our financial statements in the future.

***Costs Associated with Exit or Disposal Activities***

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 requires that liabilities associated with exit or disposal activities be recognized when a company is committed to future payment of those liabilities under a binding, legal obligation. SFAS No. 146 nullifies EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, which required that exit and disposal costs be recognized as liabilities when a company formalized its plan for exiting or disposing of an activity even if no legal obligation had been established.

SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002. Currently, we have no plans to exit or dispose of any of our business activities that would require the use of SFAS No. 146 nor do we anticipate that SFAS No. 146 will change any of our business practices.

***Gains and Losses from Extinguishment of Debt and Capital Leases***

In April 2002, the FASB issued SFAS No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*, to be applied in fiscal years beginning after May 15, 2002.

Under SFAS No. 145, gains and losses from extinguishment of debt should be classified as extraordinary items only if they meet the criteria of APB No. 30. Under APB No. 30, events are considered extraordinary only if they possess a high degree of abnormality and are not likely to recur in the foreseeable future. Any gains or losses on extinguishment of debt that do not meet the criteria of APB No. 30 shall be classified as a component of income from recurring operations. In addition, any gains or losses on extinguishment of debt that were classified as an extraordinary item in prior periods presented that do not meet the criteria of APB No. 30 shall be reclassified as a component of income from recurring operations. We adopted SFAS No. 145 on January 1, 2003.

In February 2003, we redeemed the entire principal amount of our 15.5% senior notes. This voluntary repayment resulted in the recognition of a loss on the early extinguishment of debt of \$7.4 million. We do not believe the loss meets the criteria of APB No. 30 as we have historically and may continue to change our capital structure to take advantage of current market conditions. As a result of adopting SFAS No. 145, we recorded the debt retirement costs as a component of income from recurring operations.

SFAS No. 145 also amends SFAS No. 13, *Accounting for Leases*. Under SFAS No. 145, if a capital lease is modified such that it becomes an operating lease, a gain or loss must be recognized similar to the accounting used for sale-leaseback transactions as provided in SFAS No. 28 and No. 98. At June 30, 2003, we had capital lease obligations of \$454,000; however, we currently have no plans to modify these or any future capital leases, and we do not expect SFAS No. 145 to have a material impact on our financial statements.

***Asset Retirement Obligations***

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. We adopted SFAS No. 143 on January 1, 2003 without material impact on our financial statements.

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**Risk Factors**

This Form 10-Q, including *Risk Factors* set forth below, contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they materialize or prove incorrect, could cause our results and the results of our consolidated subsidiaries to differ materially from those expressed or implied by these forward-looking statements. All statements other than statements of historical fact are statements that could be deemed forward-looking statements, including any projections of earnings, revenue or other financial items; any statements of the plans, strategies and objectives of management for future operations; any statement concerning proposed new services or developments; any statements regarding the future economic conditions or performance; any statements of belief; and any statements of assumptions underlying any of the foregoing. The risks, uncertainties and assumptions referred to above include difficulty of managing our growth and integrating our new acquisitions and other risks that are described from time to time in our Securities and Exchange Commission reports, including but not limited to the items discussed below.

***If we are unable to effectively execute our growth strategy, we may not achieve our desired economies of scale and our margins and profitability may decline.***

Our success depends in part on our ability to build on our position as a leading animal health care services company through a balanced program of internal growth initiatives and selective acquisitions of established animal hospitals and laboratories. If we cannot implement or effectively execute these initiatives and acquisitions, our results of operations will be adversely affected. Even if we effectively implement our growth strategy, we may not achieve the economies of scale that we have experienced in the past or that we anticipate having in the future. Our internal growth rate may decline and could become negative. Our laboratory internal revenue growth has fluctuated between 12.5% and 14.1% for each fiscal year from 2000 through 2002. Similarly, our animal hospital adjusted same-facility revenue growth rate has fluctuated between 3.6% and 7.0% over the same fiscal years. Our internal growth may continue to fluctuate and may be below our historical rates. Any reductions in the rate of our internal growth may cause our revenues and margins to decrease. Our historical growth rates and margins are not necessarily indicative of future results.

Demand for certain over the counter products could decline as their product life cycle matures and the products become available in more retail-oriented locations. Certain of these products are replaced and are distributed through veterinary hospitals only. This cycle and the replacement of existing products could affect veterinary visits. Demand for vaccinations may also be impacted in the future as protocols for vaccinations change. Vaccinations have been recommended by some in the profession to be given less frequently. This may result in fewer visits and potentially less revenue. Vaccine protocols for our company are established by our veterinarians who use their independent professional judgment. Some of our veterinarians have changed their protocols and others may change their protocol in light of recent literature.

***Our business and results of operations may be adversely affected if we are unable to manage our growth effectively.***

Since January 1, 1996, we have experienced rapid growth and expansion. Our failure to manage our growth effectively may increase our costs of operations and hinder our ability to execute our business strategy. Our rapid growth has placed, and will continue to place, a significant strain on our management and operational systems and resources. At January 1, 1996, we operated 59 animal hospitals, operated laboratories servicing approximately 9,000 customers in 27 states and had approximately 1,150 full-time equivalent employees. At June 30, 2003, we operated 238 animal hospitals, operated laboratories servicing approximately 14,000 customers in all 50 states and had approximately 4,000 full-time equivalent employees. If our business continues to grow, we will need to improve and enhance our overall financial and managerial controls, reporting systems and procedures, and expand, train and manage our workforce in order to maintain control of expense and achieve desirable economies of scale. We also will need to increase the capacity of our current systems to meet additional demands.

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***Due to the fixed cost nature of our business, fluctuations in our revenue could adversely affect our operating income.***

Approximately 57.2% of our expense, particularly rent and personnel costs, are fixed costs and are based in part on expectations of revenue. We may be unable to reduce spending in a timely manner to compensate for any significant fluctuations in our revenue. Accordingly, shortfalls in revenue may adversely affect our operating income.

***Difficulties integrating new acquisitions may impose substantial costs and cause other problems for us.***

Our success depends on our ability to timely and cost-effectively acquire, and integrate into our business, additional animal hospitals and laboratories. Any difficulties in the integration process may result in increased expense, loss of customers and a decline in profitability. We expect to acquire 15 to 25 animal hospitals per year, however, based on the opportunity, the number could be higher. Historically we have experienced delays and increased costs in integrating some hospitals primarily where we acquire a large number of hospitals in a single region at or about the same time. In these cases, our field management may spend a predominant amount of time integrating these new hospitals and less time managing our existing hospitals in those regions. During these periods, there may be less attention directed to marketing efforts or staffing issues. In these circumstances, we also have experienced delays in converting the systems of acquired hospitals into our systems, which results in increased payroll expense to collect our results and delays in reporting our results, both for a particular region and on a consolidated basis. These factors have resulted in decreased revenue, increased costs and lower margins. We continue to face risks in connection with our acquisitions including:

negative effects on our operating results;

impairments of goodwill and other intangible assets;

dependence on retention, hiring and training of key personnel, including specialists; and

contingent and latent risks associated with the past operations of, and other unanticipated problems arising in, an acquired business.

The process of integration may require a disproportionate amount of the time and attention of our management, which may distract management's attention from its day-to-day responsibilities. In addition, any interruption or deterioration in service resulting from an acquisition may result in a customer's decision to stop using us. For these reasons, we may not realize the anticipated benefits of an acquisition, either at all or in a timely manner. If that happens and we incur significant costs, it could have a material adverse impact on our business.

***The carrying value of our goodwill could be subject to impairment write-down.***

At June 30, 2003, our balance sheet reflected \$363.2 million of goodwill, which is a substantial portion of our total assets of \$545.3 million at that date. We expect that the aggregate amount of goodwill on our balance sheet will increase as a result of future acquisitions. We continually evaluate whether events or circumstances have occurred that suggest that the fair market value of each of our reporting units is below their carrying values. If we determine that the fair market value of one of our reporting units is less than its carrying value, this may result in an impairment write-down of the goodwill for that reporting unit. The impairment write-down would be reflected as expense and could have a material adverse effect on our results of operations during the period in which we recognize the expense. In 2002, we concluded that the fair value of our reporting units exceeded their carrying value and accordingly, as of that date, our net goodwill was fairly stated in our financial statements and there are currently no impairment issues. However, in the future we may incur impairment charges related to the goodwill already recorded or arising out of future acquisitions.

**Table of Contents*****We require a significant amount of cash to service our debt and expand our business as planned.***

We have, and will continue to have, a substantial amount of debt. Our substantial amount of debt requires us to dedicate a significant portion of our cash flow from operations to pay down our indebtedness and related interest, thereby reducing the funds available to use for working capital, capital expenditures, acquisitions and general corporate purposes.

At June 30, 2003, our debt, excluding unamortized discount, consisted primarily of:

\$166.4 million in principal amount outstanding under our senior credit facility;

\$170.0 million in principal amount outstanding under our 9.875% senior subordinated notes; and

\$2.1 million in principal amount outstanding under our other debt.

The following table sets forth the scheduled principal and interest payments that are due on our debt for each of the periods indicated (in thousands):

	Payments Due by Period				
	Total	Less than 1 year (1)	1 - 3 years	3 - 5 years	More than 5 years
Long-term debt	\$ 338,042	\$ 1,167	\$ 4,235	\$ 102,261	\$ 230,379
Fixed interest	110,721	8,658	34,519	33,945	33,599
Variable interest	54,182	5,486	23,795	22,336	2,565
Capital lease obligations	454	172	281	1	
Swap agreements	(2,763)	(674)	(2,089)		
	<u>\$ 500,636</u>	<u>\$ 14,809</u>	<u>\$ 60,741</u>	<u>\$ 158,543</u>	<u>\$ 266,543</u>

(1) Consists of the period July 1 through December 31, 2003.

We have both fixed-rate and variable-rate debt. The interest payments on our variable-rate debt are based on a variable-rate component plus a fixed 3.0%. Including the fixed 3.0%, we estimate that the total interest rate on our variable-rate debt will be 6.6%, 7.0%, 7.5%, 8.0%, 8.5% and 8.5% for years 2003 through 2008, respectively. Our consolidated financial statements included in our 2002 Annual Report on Form 10-K discuss these variable-rate notes in more detail.

We entered into the following no-fee swap agreements, which swap monthly variable LIBOR for the fixed rates indicated below:

	Swap #1	Swap #2	Swap #3
Fixed interest rate	2.22%	1.72%	1.51%
Notional amount	\$40.0 million	\$20.0 million	\$20.0 million
Effective date	11/29/2002	5/30/2003	5/30/2003
Expiration date	11/29/2004	5/31/2005	5/31/2005

Swap #2 and Swap #3 qualify for hedge accounting and we consider them to be cash flow hedging instruments. However, as of May 2003 we no longer considered Swap #1 to be a cash flow hedge because the current rate environment was significantly different than the rate environment in existence at the effective date.

Our ability to make payments on our debt, and to fund acquisitions, will depend upon our ability to generate cash in the future. Insufficient cash flow could place us at risk of default under our debt agreements or could prevent us from expanding our business as planned. Our ability to generate cash is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. Our business may not generate





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sufficient cash flow from operations, our strategy to increase operating efficiencies may not be realized and future borrowings may not be available to us under our senior credit facility in an amount sufficient to enable us to service our debt or to fund our other liquidity needs. In order to meet our debt obligations, we may need to refinance all or a portion of our debt. We may not be able to refinance any of our debt on commercially reasonable terms or at all.

### ***Our debt instruments may adversely affect our ability to run our business.***

Our substantial amount of debt, as well as the guarantees of our subsidiaries and the security interests in our assets and those of our subsidiaries, could impair our ability to operate our business effectively and may limit our ability to take advantage of business opportunities. For example, our indenture and senior credit facility:

limit our funds available to repay the 9.875% senior subordinated notes;

limit our ability to borrow additional funds or to obtain other financing in the future for working capital, capital expenditures, acquisitions, investments and general corporate purposes;

limit our ability to dispose of our assets, create liens on our assets or to extend credit;

make us more vulnerable to economic downturns and reduce our flexibility in responding to changing business and economic conditions;

limit our flexibility in planning for, or reacting to, changes in our business or industry;

place us at a competitive disadvantage to our competitors with less debt; and

restrict our ability to pay dividends, repurchase or redeem our capital stock or debt, or merge or consolidate with another entity.

The terms of our indenture and senior credit facility allow us, under specified conditions, to incur further indebtedness, which would heighten the foregoing risks. If compliance with our debt obligations materially hinders our ability to operate our business and adapt to changing industry conditions, we may lose market share, our revenue may decline and our operating results may suffer.

### ***Our failure to satisfy covenants in our debt instruments will cause a default under those instruments.***

In addition to imposing restrictions on our business and operations, our debt instruments include a number of covenants relating to financial ratios and tests. Our ability to comply with these covenants may be affected by events beyond our control, including prevailing economic, financial and industry conditions. The breach of any of these covenants would result in a default under these instruments. An event of default would permit our lenders and other debtholders to declare all amounts borrowed from them to be due and payable, together with accrued and unpaid interest. Moreover, these lenders and other debtholders would have the option to terminate any obligation to make further extensions of credit under these instruments. If we are unable to repay debt to our senior lenders, these lenders and other debtholders could proceed against our assets.

### ***The significant competition in the companion animal health care services industry could cause us to reduce prices or lose market share.***

The companion animal health care services industry is highly competitive with few barriers to entry. To compete successfully, we may be required to reduce prices, increase our operating costs or take other measures that could have an adverse effect on our financial condition, results of operations, margins and cash flow. If we are unable to compete successfully, we may lose market share.

There are many clinical laboratory companies that provide a broad range of laboratory testing services in the same markets we service. Our largest competitor for outsourced laboratory testing services is Idexx Laboratories, Inc., which currently competes or intends to compete in most of the same markets in which we operate.

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Also, Idexx and several other national companies provide on-site diagnostic equipment that allows veterinarians to perform their own laboratory tests.

Our primary competitors for our animal hospitals in most markets are individual practitioners or small, regional, multi-clinic practices. Also, regional pet care companies and some national companies, including operators of super-stores, are developing multi-regional networks of animal hospitals in markets in which we operate. Historically, when a competing animal hospital opens in close proximity to one of our hospitals, we have reduced prices, expanded our facility, retained additional qualified personnel, increased our marketing efforts or taken other actions designed to retain and expand our client base. As a result, our revenue may decline and our costs increase.

***We may experience difficulties hiring skilled veterinarians due to shortages that could disrupt our business.***

As the pet population continues to grow, the need for skilled veterinarians continues to increase. If we are unable to retain an adequate number of skilled veterinarians, we may lose customers, our revenue may decline and we may need to sell or close animal hospitals. As of June 30, 2003, there were 28 veterinary schools in the country accredited by the American Veterinary Medical Association. These schools graduate approximately 2,100 veterinarians per year. There is a shortage of skilled veterinarians across the country, particularly in some regional markets in which we operate animal hospitals including Northern California. During these shortages in these regions, we may be unable to hire enough qualified veterinarians to adequately staff our animal hospitals, in which event we may lose market share and our revenues and profitability may decline.

***If we fail to comply with governmental regulations applicable to our business, various governmental agencies may impose fines, institute litigation or preclude us from operating in certain states.***

The laws of many states prohibit business corporations from providing, or holding themselves out as providers of, veterinary medical care. These laws vary from state to state and are enforced by the courts and by regulatory authorities with broad discretion. As of June 30, 2003 we operated 64 animal hospitals in 11 states with these laws, including 21 in New York. We may experience difficulty in expanding our operations into other states with similar laws. Given varying and uncertain interpretations of the veterinary laws of each state, we may not be in compliance with restrictions on the corporate practice of veterinary medicine in all states. A determination that we are in violation of applicable restrictions on the practice of veterinary medicine in any state in which we operate could have a material adverse effect on us, particularly if we were unable to restructure our operations to comply with the requirements of that state.

All of the states in which we operate impose various registration requirements. To fulfill these requirements, we have registered each of our facilities with appropriate governmental agencies and, where required, have appointed a licensed veterinarian to act on behalf of each facility. All veterinarians practicing in our clinics are required to maintain valid state licenses to practice.

***Any failure in our information technology systems or disruption in our transportation network could significantly increase testing turn-around time, reduce our production capacity and otherwise disrupt our operations.***

Our laboratory operations depend, in part, on the continued and uninterrupted performance of our information technology systems and transportation network. Our growth has necessitated continued expansion and upgrade of our information technology systems and transportation network. Sustained system failures or interruption in our transportation network or in one or more of our laboratory operations could disrupt our ability to process laboratory requisitions, perform testing, provide test results in a timely manner and/or bill the appropriate party. We could lose customers and revenue as a result of a system or transportation network failure.

Our computer systems are vulnerable to damage or interruption from a variety of sources, including telecommunications failures, electricity brownouts or blackouts, malicious human acts and natural disasters. Moreover, despite network security measures, some of our servers are potentially vulnerable to physical or electrical break-ins, computer viruses and similar disruptive problems. Despite the precautions we have taken, unanticipated

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problems affecting our systems could cause interruptions in our information technology systems. Our insurance policies may not adequately compensate us for any losses that may occur due to any failures in our systems.

In addition, over time we have significantly customized the computer systems in our laboratory business. We rely on a limited number of employees to upgrade and maintain these systems. If we were to lose the services of some or all of these employees, it may be time-consuming for new employees to become familiar with our systems, and we may experience disruptions in service during these periods.

Any substantial reduction in the number of available flights or delays in the departure of flights, whether as a result of severe weather conditions, as we recently experienced in the eastern United States, a terrorist attack or any other type of disruption, will disrupt our transportation network and our ability to provide test results in a timely manner. In addition, our Test Express service, which services customers outside of major metropolitan areas, is dependent on flight services in and out of Memphis and the transportation network of Federal Express. Any sustained interruption in either flight services in Memphis or the transportation network of Federal Express would result in increased turn-around time for the reporting of test results to customers serviced by our Test Express service.

***The loss of Mr. Robert Antin, our Chairman, President and Chief Executive Officer, could materially and adversely affect our business.***

We are dependent upon the management and leadership of our Chairman, President and Chief Executive Officer, Robert Antin. We have an employment contract with Mr. Antin which may be terminated at the option of Mr. Antin. We do not maintain any key man life insurance coverage for Mr. Antin. The loss of Mr. Antin could materially adversely affect our business.

***Concentration of ownership among our existing executive officers, directors and principal stockholders may prevent new investors from influencing significant corporate decisions.***

Our executive officers, directors and principal stockholders beneficially own, in the aggregate, 25.4% of our outstanding common stock. As a result, these stockholders are able to significantly affect our management, our policies and all matters requiring stockholder approval. The directors supported by these stockholders will be able to significantly affect decisions relating to our capital structure, including decisions to issue additional capital stock, implement stock repurchase programs and incur indebtedness. This concentration of ownership may have the effect of deterring hostile takeovers, delaying or preventing changes in control or changes in management, or limiting the ability of our other stockholders to approve transactions that they may deem to be in their best interests.

***Political and military events and the uncertainty resulting from them may have a material adverse effect on our operating results.***

The United States military's continuing involvement in Iraq, the terrorist attacks which took place in the United States on September 11, 2001, the United States military campaign against terrorism, ongoing violence in the Middle East and the increasing concern with respect to developments in North Korea have created many economic and political uncertainties, some of which may affect the markets in which we operate, our operations and profitability and your investment. The potential near-term and long-term effect that political uncertainty, armed conflict and possible terrorist and other attacks may have for our customers, the markets for our services and the U.S. economy are uncertain. The consequences of our involvement in Iraq and any terrorist attacks or other armed conflicts are unpredictable and we may not be able to foresee events that could have an adverse effect on our markets, our business or your investment.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As of June 30, 2003, we had borrowings of \$166.4 million under our senior credit facility with fluctuating interest rates based on market benchmarks such as LIBOR. To reduce the risk of increasing interest rates, we have entered into three separate no-fee interest rate swap agreements. The first agreement is for \$40.0 million and commenced on November 29, 2002 and expires November 29, 2004. The second agreement is for \$20.0 million and

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commenced on May 30, 2003 and expires May 31, 2005. The third agreement is for \$20.0 million and commenced on May 30, 2003 and expires May 31, 2005. These swap agreements have the effect of reducing the amount of our debt exposed to variable interest rates from \$166.4 million to \$86.4 million. Accordingly, for the next 12-month period, for every 1.0% increase in the LIBOR rate we will pay an additional \$864,000 in interest expense and for every 1.0% decrease in the LIBOR rate we will save \$864,000 in interest expense.

We are considering entering into additional interest rate strategies to take advantage of the current rate environment. We have not yet determined what those strategies may be or their possible impact.

**ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, we have carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic reports with the Securities and Exchange Commission.

In accordance with the requirements of the Securities and Exchange Commission, our Chief Executive Officer and Chief Financial Officer note that, since the date of the most recent evaluation of our disclosure controls and procedures to the date of this quarterly report on Form 10-Q, there have been no significant changes in our internal controls or in other factors that could significantly affect internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

As previously disclosed, the litigation between VCA, Zoasis Corporation and Robert Antin and two majority stockholders of a company that merged with Zoasis, was dismissed with prejudice on April 17, 2003 pursuant to the settlement agreement announced in our 2002 annual report on Form 10-K.

We are a party to various legal proceedings that arise in the ordinary course of business. Although we cannot determine the ultimate disposition of these proceedings, we can use judgment to reasonably estimate our liability for legal settlement costs that may arise as a result of these proceedings. Based on our prior experience, the nature of the current proceedings and our insurance policy coverage for such matters, we have accrued \$1.9 million as of June 30, 2003 for legal settlements as part of other accrued liabilities.

**Table of Contents****ITEM 2. CHANGES IN SECURITIES**

None

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

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

On May 28, 2003, we held our annual meeting of stockholders at which our stockholders:

elected three Class I directors;

approved an additional 1,500,000 shares of our common stock to be reserved for issuance under our 2001 Stock Incentive Plan; and

ratified KPMG LLP as our independent auditor.

The names of the three nominees elected to serve as our Class I directors and the results of the election are as follows:

<u>Candidates</u>	<u>Yes Votes</u>	<u>No Votes</u>	<u>Abstain</u>	<u>Broker-Non-Vote</u>
Arthur J. Antin	27,077,087		5,549,014	
John M. Baumer	31,859,432		766,669	
Frank Reddick	26,872,732		5,753,369	

The results of the other two matters upon which our stockholders voted are as follows:

<u>Proposal</u>	<u>Yes Votes</u>	<u>No Votes</u>	<u>Abstain</u>	<u>Broker-Non-Vote</u>
Reserve additional 1,500,000 shares of common stock for issuance under our 2001 Stock Incentive Plan	19,761,751	12,845,080	19,270	
Ratify KPMG LLP as our independent auditor	3,554,136	54,580	17,385	

**ITEM 5. OTHER INFORMATION**

None

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**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

(a) Exhibits:

- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K:

- (1) Report on Form 8-K, filed April 25, 2003, under item 5, updated financial guidance for the fiscal year 2003, and under item 12, provided financial information for the three months ended March 31, 2003.

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**SIGNATURE**

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, in the City of Los Angeles, State of California, on today's date, September 9, 2003.

By: /s/ Tomas W. Fuller

\_\_\_\_\_  
Tomas W. Fuller  
Its: Chief Financial Officer

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**EXHIBIT INDEX**

31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	1
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	2
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	3