SRI SURGICAL EXPRESS INC
Form 10-K
March 31, 2003
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2002

Commission File No. 000-20997

SRI/SURGICAL EXPRESS, INC.

(Exact name of registrant as specified in its charter)

Florida	**59-3252632**
(State of Incorporation)	**(IRS Employer Identification No.)**
12425 Race Track Road, Tampa, Florida	**33626**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (813) 891-9550

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $.001

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. **YES x NO o**

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based upon the closing sale price of the Common Stock on February 14, 2003, as reported on the Nasdaq National Market, was approximately $18,995,243.

The Registrant had outstanding 6,268,877 shares of Common Stock as of March 3, 2003.

DOCUMENTS INCORPORATED BY REFERENCE

The Registrant s Proxy Statement for the 2003 Annual Meeting of Shareholders to be held on May 14, 2003 is incorporated by reference in Part III of this report to the extent stated herein.

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SRI/SURGICAL EXPRESS, INC.
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PART I

ITEM 1. BUSINESS

SRI/Surgical Express, Inc.® (SRI or the Company) provides hospitals and surgery centers with a comprehensive surgical procedure-based daily delivery service. The foundations of this service are SRI s reusable surgical products, including gowns, towels, drapes, basins, and instruments, and its daily delivery and retrieval of these products for each customer. To provide its customers with a comprehensive offering for surgical procedures, the Company complements these reusable products with cost-effective disposable accessory packs and individual single sterile disposable items. SRI® believes its superior quality reusable products and its service solutions, including direct delivery to its customers departments, differentiate SRI from its competitors.

At eleven regional facilities, SRI collects, sorts, cleans, inspects, packages, sterilizes, and delivers its reusable products on a just-in-time basis. SRI offers an integrated closed-loop reprocessing service that uses two of the most technologically advanced reusable textiles: (i) a GORE® Surgical Barrier Fabric for gowns and drapes that is breathable yet liquidproof and provides a viral/bacterial barrier and (ii) an advanced microfiber polyester surgical fabric for gowns and drapes, which is liquid and bacterial resistant.

SRI s Surgical Express® program uses daily delivery and retrieval to provide customers with an expanded program of products and services. Surgical Express is an outsourced Surgical Case Cart Management Program that reduces hospital and surgery centers processing costs and their investment in surgical products. The Company supplements its core reusable products offering with disposable accessory packs containing smaller surgical items that are not reusable, such as needles, syringes, and tubing. The Company believes that its customers benefit significantly from the flexibility offered by its combination of reusable surgical gowns, towels, drapes, and basins with disposable products and instruments.

SRI believes that Surgical Express is a superior quality and competitively-priced alternative to a full disposable program, other procedure-based surgical supply programs, and operating an in-house reusable program for surgical products. The Company s delivery service offers savings to hospitals by reducing or eliminating the following costly steps associated with the disposable or in-house alternatives: (i) disposing of biohazardous wastes, (ii) carrying an inventory of disposable surgical products, including costly disposable instruments, and (iii) in-house processing of reusable surgical products. In addition to these cost savings, the Company s liquidproof and liquid resistant gowns offer surgeons and surgical staff enhanced protection against transmission of blood-borne pathogens, including the HIV and hepatitis viruses, and the Company s reusable gowns are made with a breathable surgical fabric, which is designed for superior comfort during long procedures. Also, the Company believes hospitals are attracted by the convenience of its complete supply management program that is provided and billed on a per-procedure basis.

In 2000, SRI introduced to its customers its first complete procedure-based service, Surgical Express for Laparoscopy, which combines its core reusable products offering with disposable products and laparoscopic instruments required for laparoscopic surgical procedures. The Company charges customers a single procedure price for the supplies and instruments required for a laparoscopic procedure. The Company now offers it customers procedure-based services for orthopedic, general instrument, and labor and delivery surgical procedures and expects to continue developing new instrument programs. As of December 31, 2002, the Company was servicing 60 instrument projects at 27 hospitals from eight of its facilities.

The Company offers its instrument programs pursuant to a Joint Marketing Agreement dated April 28, 2000 with Aesculap, Inc., one of the oldest and largest worldwide suppliers of surgical instruments. The agreement expires in April 2003, but the parties are negotiating a renewal that would extend the relationship for a significant term. The agreement provides for Aesculap to furnish and repair laparoscopic instruments. The Company delivers, retrieves, and reprocesses the instruments and is responsible for customer relationships. Aesculap receives an agreed share of the revenues from each procedure based on the number and kinds of procedures and the number and combination of instruments for each procedure. See Business Certain Considerations New Product Offering; Dependence on a Supplier.

As of December 31, 2002, SRI serves a customer base of approximately 325 hospitals and surgery centers located in 24 states and the District of Columbia. SRI is increasingly focused on large networks of hospitals.

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The Company maintains agreements to supply several group purchasing organizations, including most significantly Novation and HealthTrust Purchasing Group (HPG). Novation is the supply company for Voluntary Hospitals of America (VHA) and University HealthSystem Consortium (UHC). SRI offers Novation members its Surgical Express program as a unitized delivery system featuring reusable surgical textiles, reusable instruments, and disposable accessory packs. HealthTrust Purchasing Group (HPG) is a group purchasing organization representing over 600 hospitals and surgery centers. The contract with HPG designates SRI as its primary outsource vendor for reusable surgical products, including instruments. With its Novation, HPG and other agreements, Surgical Express is an available contracted alternative for over 2,000 hospitals and surgery centers across the country. The Company continues to pursue additional group purchasing organization contracts that would allow it to further penetrate the surgical supply market.

The Market

The United States health care system includes approximately 7,000 acute care hospitals, over 2,750 freestanding surgery centers, and a variety of other health care facilities. According to industry sources, approximately 40 million surgical procedures were performed at hospitals and surgery centers in 2002. The Company believes that between $100-$150 of surgical products service revenues, including $30-$50 from reusable products, can be realized from a typical surgical procedure. SRI estimates that revenue of between $200 and $400 typically can be realized from procedures such as laparoscopies, in which instruments are provided.

In the 1980 s, hospitals began using custom procedure trays because of their convenience. This trend continued growing throughout the 1990 s. A custom procedure tray typically contains, in disposable form, most of the sterile products used in a particular surgical or other medical procedure. Industry sources estimate total annual sales of custom procedure trays in the United States to be $1.5 billion, an amount that appears to have been stable over the last three to four years. The Company believes that custom procedure trays suffer shortcomings in comparison to reusable products, including costs associated with excessive product content, storage, handling and waste disposal, lost instruments and the working capital requirements required to carry product inventory.

Hospitals that use custom procedure trays generally do not have in-house personnel and equipment used to process reusable surgical products. Furthermore, hospitals that have in-house facilities are increasingly unwilling to support the personnel and capital needs required to operate those facilities. Especially with the growth of managed care and associated decrease in surgical service reimbursements, hospitals are seeking to significantly reduce their costs. The Company believes that these hospitals will purchase a service that provides daily delivery of substantially better quality surgical products, eliminates their capital investment requirements, and reduces their employee and space demands.

The following market conditions provide continuing opportunities for SRI s Surgical Express program:

Continued Pressure on Hospitals to Contain Costs and Improve Profitability. With the growth of managed care and a decrease in surgical service reimbursements, economic constraints continue to require hospitals to become more efficient by limiting capital investments and reducing staff and costs. Hospitals are continually seeking to decrease their cost of operations, including supplies and waste disposal. SRI s service eliminates the need for in-house inventory or processing facilities and the process costs associated with stocking and discarding disposable products.

Concern Regarding the Transmission of Infectious Diseases. The health care industry must manage risks of transmission of infectious diseases from cross-infections. These concerns increase the desirability of surgical barrier fabrics that protect surgeons and surgical staff from patient liquids. SRI s liquidproof gown prevents liquid and viral strike-through in critical areas during surgical procedures involving higher risk. The Company s standard gown is specially designed to resist liquid and bacterial strike-through in most other surgical procedures.

Concern Regarding the Handling and Disposal of Biohazardous Waste. The disposal of large volumes of infectious and hazardous waste generated by the health care industry continues to attract increased public awareness. The increased burdens on hospitals generating biohazardous waste due to restrictions on incineration and access to dump sites offer an advantage to reprocessing systems, which replace disposable surgical products with reusable surgical products. The SRI reprocessing system substantially reduces biohazardous waste and its impact on the environment.

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Increased Outsourcing of Hospital Functions That Do Not Involve Patient Care. Hospitals with significant staff, capital and space dedicated to in-house processing of reusable surgical products are increasingly outsourcing this function to more efficient outside providers. This trend is consistent with the overall industry focus on efficiency and improved patient care. Surgical Express allows hospitals to outsource to SRI the ownership and reprocessing of surgical products, including instruments as well as inventory management of complementary disposable products.

Strategy

The Company s objective is to continue its growth and become the preferred surgical supply solution. The Company s principal strategies for achieving this objective are as follows:

Leverage Infrastructure With Increased Penetration in Existing Markets. The Company believes its existing facilities currently operate at approximately 20-25% of their aggregate annual revenue capacity. The Company has increased this facility revenue capacity by modifying its service to include instrument processing and adding instrument reprocessing capability at its facilities. SRI serves several large metropolitan areas through highway transport and satellite distribution centers supported by a regional facility. Under its Surgical Express program, the Company operates service centers that enable the Company to service larger accounts and provide closer customer contact, enabling the Company to move into selected markets without constructing a new facility.

Help Solve Hospitals Cost Issues. The Company believes that its service addresses hospitals needs to reduce operating costs. More importantly, when fully implemented, SRI s Surgical Express program offers hospitals more comprehensive value by reducing product expenditures, supply chain process costs, biohazardous waste, and instrument costs. Under its Surgical Express programs, the Company provides hospitals an attractive per procedure billing arrangement that allows them to easily identify that cost component of their services.

Expand National and Regional Agreements. The Company s existing service agreements are primarily with individual hospitals. To leverage their purchasing power, many hospitals have joined in large groups and increasingly in recent years, smaller independent delivery networks. These smaller networks believe that they can negotiate and control their product supply more effectively than large group purchasing organizations. SRI maintains arrangements to supply two national group purchasing organizations, Novation (the supply company for VHA and UHC) and HPG (see Business Group Purchasing Agreements). As a key part of its marketing strategy, management offers its Surgical Express Program to national and regional hospital groups, as well as the individual hospitals that have been SRI s customer base.

Utilize Operational Knowledge. The Company designed and developed its 11 facilities and has gained substantial knowledge by operating them since it s inception. The Company continues to supplement that expertise through processing and engineering experience with instruments and other products. The Company believes that no other supplier offers comparable knowledge and experience in the reusable product segment.

Delivery, Retrieval and Reprocessing System

SRI s Surgical Express procedure-based service furnishes hospital customers the products needed for a particular surgical procedure, including reusable packs, disposable accessory packs, single sterile items, and instruments. Following a procedure, the hospital discards the small amount of disposable products used and places soiled reusable products into SRI s lockable carts.

SRI s closed-loop reprocessing service picks up soiled reusable surgical products from its customers and sorts, cleans, inspects, packages, sterilizes, and redelivers the products to customers. SRI s trucks deliver clean carts of sterilized surgical products to the hospital or surgical center and retrieve carts containing soiled products and return them to its facility for reprocessing. The specially designed aluminum carts that hold sterile product are lockable to maintain security. Carts conveniently roll for delivery within the hospital and convert into hampers to hold soiled or used products after the procedure. The customer avoids the need to maintain secondary stock locations and the costs of either reprocessing reusable products or stocking and discarding disposable products.

Upon return to SRI s facility, the contents of the soiled carts are sorted by product type in a controlled area and transferred to the appropriate area for processing and decontamination. Soiled linen products are processed through an

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automated washing and drying process that delivers clean and decontaminated products to the pack room floor, where they are carefully inspected, repaired if necessary, folded, and assembled into packs. Surgical instruments and other stainless products are segregated and processed through specially designed processes by trained instrument technicians. SRI processes high quality reusable instruments designed to be thoroughly cleaned and decontaminated. Following the cleaning/ decontamination process, each instrument is inspected and tested for functionality prior to being included in a pack/ instrument set. Stainless steel basin components, delivery carts and other reusable products are processed through automated tunnel washers before reuse. Following assembly, packs are steam sterilized and combined with complementary disposable packs for delivery to the customers. All processing is performed in accordance with documented procedures.

The Company closely monitors its processes to ensure its reusable products useful lives are fully realized. To accurately track its amortization expense, SRI uses a barcoding system, which maintains its reusable surgical products status, history, and number of uses.

Customers

The growth of SRI s business since its inception reflects its products appeal, its service quality, and general customer resistance to change when the SRI system is in place. SRI also believes its direct relationships with hospitals staffs have been important in attracting and retaining customers. Many of SRI s competitors use a distributor system that introduces an intermediary between the competition and their customers, which SRI believes adds costs and reduces customer contact.

The Company s sales process for new customers is typically six to eighteen months in duration from initial contact to a purchase commitment. The extended sales process is typically due to the complicated approval process within hospitals for purchases from new suppliers, the long duration of existing supply contracts, and implementation delays pending termination of a hospital s previous supply relationships. Conversely, SRI s high service level, quality products, and customer resistance to change help SRI retain its existing customers.

SRI bills its customers weekly for the previous week s deliveries under service contracts or purchase orders. A signed and dated packing slip and a randomly generated delivery confirmation number evidences confirmation of deliveries. Consistent with industry custom, customer service contracts generally are cancelable by either party with 90 days notice, and customers may, without penalty, unilaterally reduce their use of the Company s services under these contracts. Surgical Express contracts have longer terms, typically three to five years, with more stringent cancellation provisions.

Products

SRI s principal reusable surgical products are its liquidproof and liquid resistant surgical gowns, towels, drapes, and stainless steel basin sets. SRI offers these products in a variety of packs configured to the hospital s specific needs. Packs are comprised of various combinations of gowns, absorbent towels, liquidproof backtable covers, mayo stand covers, and stainless components.

The Company s liquidproof gown has GORE® Surgical Barrier Fabric in critical areas to provide protection for procedures that present a higher risk of liquid strike-through. This protection is critical to SRI s customers given continuing concerns of doctors, staff, and regulatory authorities regarding transmission of blood-borne pathogens, including the HIV and hepatitis viruses. The Gore Surgical Barrier fabric is a liquidproof, breathable material providing additional protection for the surgical staff while allowing for continued comfort during longer procedures. The Company s liquid resistant gown is made of an advanced microfiber polyester fabric designed to resist liquid and bacterial strike-through in most surgical procedures. All of SRI s gowns and drapes offer the wearer both comfort and breathability, combined with a high level of protection from liquid penetration that SRI believes is superior to that offered by disposable products.

SRI contracts with third-party vendors for the weaving of microfiber fabric and the cutting and sewing of garments, wraps, and drapes. In August 1998, the Company signed a ten-year sales and manufacturing agreement with Standard Textile Co., Inc., under which Standard Textile manufactures the bulk of SRI s reusable textile products with fabric provided by W.L. Gore and other textile suppliers. The other components of the Company s products are currently available at reasonable costs from a variety of suppliers. To complement its reusable surgical products, the Company offers disposable accessory packs containing smaller surgical products, such as needles, syringes, and tubing. The Company develops these packs with its customers cooperation to assure a desirable and cost-effective product mix. SRI purchases the products from

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major manufacturers, assembles the products in packs, arranges for ethylene oxide sterilization by a third party, and delivers them to customers on its carts with its reusable products. The Company s product offering also includes selected reusable instruments. SRI offers general, laparoscopic, orthopedic and labor and delivery instruments through its Surgical Express service for surgical procedures. The service includes instruments and reusable and disposable products needed for particular surgical procedures.

Employees

As of December 31, 2002, SRI employed 984 people, consisting of 60 persons in management, administration and finance at its corporate office and 924 people in various positions at the Company s facilities. The Company s employees are not covered by a collective bargaining agreement. The Company considers its employee relations to be good.

Competition

SRI competes with sellers of both reusable and disposable gowns, drapes, basins, and other products for surgical procedures. This product market is dominated by disposables, especially custom procedure trays. SRI believes it is the leading provider of high quality reusable surgical gowns and drapes, and that with its Surgical Express Program, SRI effectively competes with suppliers of disposable custom procedure trays.

Unlike SRI, many of SRI s competitors offer full national coverage. Some of these competitors have much greater resources than the Company. The Company s principal competitors are Allegiance Corporation (a subsidiary of Cardinal Health, Inc.), which has a substantial market share, Medline Industries, Inc., Maxxim Medical Inc., and Kimberly-Clark Corporation.

The Company competes based primarily on price, service, quality, process improvement, and its ability to save its customers waste disposal costs. The changing healthcare environment in recent years has led to increasingly intense competition among health care suppliers based on price, service, and product performance. Hospitals are seeking cost reductions in response to pressure from governments, insurance companies, and health maintenance organizations. The Company believes its high level of operating expertise significantly benefits it in offering a superior product at a competitive cost. Hospitals increasingly seek buying leverage by purchasing in integrated networks. SRI believes that competitive pressure in these areas will continue.

Regulation

Substantially all of the Company s products and services are subject to extensive government regulation in the United States by federal, state, and local governmental agencies, including the Food and Drug Administration (the FDA), the Department of Transportation (DOT), and the Occupational Safety and Health Administration (OSHA).

The Company s reusable products are regulated as medical devices by the FDA, which regulates the development, production, distribution, and promotion of medical devices in the United States. Various states in which the Company does business also regulate medical devices. Pursuant to the Federal Food Drug and Cosmetics Act (the FDA Act), the Company s medical devices are subject to general controls regarding FDA inspections of facilities, Current Good Manufacturing Practices (cGMP s), labeling, maintenance of records, and medical device reporting with the FDA. To the extent required, the Company has obtained FDA pre-market approval of its devices under Section 510(k) of regulations issued under the FDA Act, which provides for FDA approval on an expedited basis for products shown to be substantially equivalent to devices already cleared by the FDA and currently legally marketable in the United States. Products must be produced in establishments registered with the FDA and manufactured in accordance with cGMP s, as defined under the FDA Act. The cGMP requirements have been substantially revised and incorporated into what is now known as the Quality System Regulation, or QSR, (21 CFR Part 820). Since the QSRs were first issued on June 1, 1997, the focus of most routine FDA inspections has been compliance with these new regulations. In addition, the Company s medical devices must be initially listed with the FDA, and its labeling and promotional activities are subject to scrutiny by the FDA and, in certain instances, by the Federal Trade Commission. The Medical Device Reporting regulation obligates the Company to provide information to the FDA on injuries or deaths alleged to have been associated with the use of a product or in connection with certain product failures that could have caused serious injury or death. If the Company fails to comply with the applicable provisions of the FDA Act, the FDA may

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institute proceedings to detain or seize products, impose fines, enjoin future company activities, impose product labeling restrictions, or enforce product recalls or withdrawals from the market.

The Company and its hospital customers also must comply with regulations of OSHA, including the bloodborne pathogen rule requiring standard universal precautions be observed to minimize exposure to blood and other bodily fluids. To comply with these requirements, the Company s employees wear personal protective equipment when handling soiled linens in the facility s decontamination area. Properly used, the Company s products allow its hospital customers to protect their employees in compliance with these regulations. The Company must comply with local regulations governing the discharge of water used in its operations. The Company uses local licensed contractors to dispose of any biohazardous waste generated by the hospital and received by the Company and therefore does not need to obtain permits for biohazardous waste disposal. The Company must comply with DOT and OSHA regulations governing the transportation of biohazardous materials, which include containing and labeling waste as well as reporting various discharges. The Company complies with these regulations by confining soiled products inside marked liquidproof bags for transport within locked, marked transfer carts. Sterilization of the Company s disposable accessory packs is provided by a third-party contractor. The use of ethylene oxide by the contractor in the sterilization of the Company s disposable accessory packs is subject to regulation by FDA, OSHA, and the Environmental Protection Agency.

In addition to the foregoing, other federal, state and local regulatory authorities, including those enforcing laws which relate to the environment, fire hazard control, and working conditions, have jurisdiction to take actions that could have a material adverse effect on the Company. The Company makes expenditures from time to time to comply with environmental regulations, but does not expect any material capital expenditure for environmental compliance in 2003.

As of December 31, 2002, the Company knows of no pending issues with any regulatory authorities which could have a materially adverse affect on the Company.

Certain Considerations

This report, other documents that are publicly disseminated by the Company, and oral statements that are made on behalf of the Company contain or might contain both statements of historical fact and forward-looking statements. Examples of forward-looking statements include: (i) projections of revenue, earnings, capital structure, and other financial items, (ii) statements of the plans and objectives of the Company and its management, (iii) statements of future economic performance, and (iv) assumptions underlying statements regarding the Company or its business. The cautionary statements set forth below discuss important factors that could cause actual results to differ materially from any forward-looking statements.

Sales Process and Market Acceptance of Products and Services. The Company s future performance depends on its ability to increase revenues from new and existing customers. The Company s sales process for new customers is typically between six and eighteen months in duration from initial contact to purchase commitment. The extended sales process is typically due to the complicated approval process within hospitals for purchases from new suppliers, the long duration of existing supply contracts, and implementation delays pending termination of a hospital s previous supply relationships. The long sales process inhibits the ability of the Company to quickly increase revenues from new and existing customers or enter new markets. SRI s future performance will also depend on market acceptance of its combination of reusable surgical products, disposable accessory packs, and direct delivery and retrieval service. See Business The Market.

Need for Capital. The Company s business is capital intensive and will require substantial expenditures for additional surgical products and equipment during the next several years to achieve its operating and expansion plans. To adequately service a new customer, SRI typically makes an investment in new reusable surgical products and carts of approximately 40% of the projected new annual revenue from the customer. The Company s inability to obtain adequate debt or equity capital would have a material adverse effect on the Company. See Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources and Note D of Notes to Consolidated Financial Statements.

New Product Offering; Dependence on a Supplier. The Company is regularly developing new instrument processing programs. The Company is subject to a risk that the market will not broadly accept them. Further, the Company relies on Aesculap, Inc. as its major source of supply of instruments for its instrument programs. The Joint Marketing Agreement between SRI and Aesculap that provides for Aesculap to furnish instruments to the Company is set to expire in April 2003, and

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the parties are negotiating its renewal. Any failure of Aesculap to furnish instruments for any reason would materially and adversely affect the Company s ability to service this program until SRI secured one or more alternative suppliers.

Dependence on Significant Customers and Market Consolidation. During 2002, Novation, HPG, and Premier, Inc. hospitals accounted for approximately 34%, 14%, and 11% of the Company s sales, compared to 31%, 13%, and 16% in 2001, respectively. Although each Novation, HPG, and Premier hospital currently makes its purchasing decisions on an individual basis, and no single hospital accounted for more than 6% of the Company s sales, the loss of a substantial portion of the Novation, Premier, or HPG hospitals business would have a material adverse effect on the Company.

Competition. The Company s business is highly competitive. Competitors include a number of distributors and manufacturers, as well as the in-house reprocessing operations of hospitals. Certain of the Company s existing and potential competitors possess substantially greater resources than the Company. Some of the Company s competitors, including Allegiance Corporation (a subsidiary of Cardinal Health, Inc.) and Medline Industries, Inc., serve as the sole supplier of a wide assortment of products to a significant number of hospitals. While the Company has a substantial array of surgical products, many of its competitors have a greater number of products for the entire hospital, which in some instances is a competitive disadvantage for the Company. There is no assurance that the Company will be able to compete effectively with existing or potential competitors. See Business Competition.

Pending SEC Investigation. As previously disclosed, the Company is cooperating with a pending investigation by the Securities and Exchange Commission (SEC), which is primarily focused on the Company s accounting for transactions underlying its restatement of its financial results for the third quarter of 2001. Although SRI has reached preliminary agreement with the SEC s staff regarding a settlement with respect to its investigation, this settlement remains subject to documentation and Commission authorization. Further, the settlement covers only SRI and the named individuals. See Legal Proceedings.

Government Regulation. Significant aspects of the Company s businesses are subject to state and federal statutes and regulations governing, among other things, medical waste disposal and workplace health and safety. In addition, most of the products furnished or sold by the Company are subject to regulation as medical devices by the U.S. Food and Drug Administration, as well as by other federal and state agencies. The Company s facilities are subject to quality systems inspections by FDA officials. The FDA has the power to enjoin future violations, seize adulterated or misbranded devices, require the manufacturer to remove products from the market, and publicize relevant facts. Federal or state governments might impose additional restrictions or adopt interpretations of existing laws that could materially and adversely affect the Company.

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ITEM 2. PROPERTIES

The Company operates eleven processing facilities that range in size between 23,000 and 63,500 square feet in Baltimore, Chattanooga, Cincinnati, Dallas, Detroit, Houston, Los Angeles, Raleigh, Salt Lake City, Stockton, and Tampa. Each facility has standardized processes and equipment including computerized and fully automated heavy duty washers, dryers, and sterilizers to achieve consistent decontamination and sterilization for reusable surgical products and instruments. The Company uses Good Manufacturing Practices at each facility, and regularly implements at all facilities efficiencies that have been developed and tested at one location.

The Company s properties and the major markets that they serve are summarized below. SRI owns its Chattanooga, Cincinnati, Houston, and Stockton processing facilities; it leases the remaining processing facilities. The Company also leases its Disposable Accessory Pack facility in Plant City, Florida, where it assembles and packages surgical products into customer specific disposable accessory packs. The Company transports these disposable accessory packs to a third party facility for sterilization. The Company believes its existing facilities adequately serve its current requirements.

Facility and Location	Sq. Ft. (Approx.)	Lease Expiration	Selected Markets Served
Processing facilities:			
Baltimore, Maryland	58,700	February 28, 2007 (Options to 2012)	Baltimore, Philadelphia, Richmond, New Jersey, Washington D.C. Massachusetts,
Chattanooga, Tennessee	50,000	Owned	Atlanta, Birmingham, Nashville
Cincinnati, Ohio	50,000	Owned	Columbus, Akron, Cincinnati, Louisville, Lexington
Dallas, Texas	49,700	March 31, 2005 (Options to 2010)	Dallas, Oklahoma City, Tulsa
Detroit, Michigan	23,000	September 30, 2007 (Options to 2012)	Chicago, Detroit, Milwaukee, Toledo, Flint, Cleveland, Ann Arbor
Houston, Texas	30,000	Owned	Houston, San Antonio, Austin
Los Angeles, California	30,400	November 30, 2007 (Options to 2012)	San Diego, Los Angeles, Arizona
Raleigh, North Carolina	63,500	April 30, 2007 (Options to 2012)	South Carolina, North Carolina
Salt Lake City, Utah	31,800	July 5, 2006 (Options to 2018)	Utah, Idaho
Stockton, California	57,000	Owned	Sacramento, San Francisco, Oakland
Tampa, Florida	63,000	January 23, 2012 (Options to 2032)	Tampa, Miami, Orlando, Jacksonville, Gainesville, Ocala, Ft. Myers, Ft. Lauderdale
Service centers:			
Chicago, Illinois	3,200	November 30, 2003	
Louisville, Kentucky	10,000[(1)]		
Miami, Florida	4,000	January 31, 2005	
Oklahoma City, Oklahoma	3,600	September 1, 2003	
Southborough, Massachusetts	13,600	June 30, 2005	
Warehouses:			
Detroit, Michigan	11,000	November 30, 2003	
Long Beach, California	3,300	July 31, 2007	
Disposable products facility:			
Plant City, Florida	40,800	November 1, 2004	

		(Options to 2009)
Corporate office:		
Tampa, Florida	42,000	April 3, 2021

(1) Service center provided by hospital

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ITEM 3. LEGAL PROCEEDINGS

SEC Investigation. The Company is cooperating with a previously disclosed investigation by the Securities and Exchange Commission that is focused primarily on the Company s accounting transactions underlying a restatement of its financial results for the third quarter of 2001. SRI announced the restatement on November 27, 2001, shortly after it initially reported the results on October 25, 2001.

SRI has preliminarily agreed with the staff of the Securities and Exchange Commission to a settlement with respect to this investigation. In the proposed settlement, without admitting or denying the SEC s findings, SRI and two of its former officers, Wayne R. Peterson and James T. Boosales, would consent to an administrative cease and desist order regarding books and records, internal controls, and reporting provisions of the Securities Exchange Act of 1934. No penalties or other monetary fines would be assessed. The SEC would not make any finding of fraud by SRI or any of the named individuals. Mr. Peterson and Mr. Boosales each retired from his position as an Executive Vice President of SRI in December 2002 and each remains a director of the Company. The settlement would not require any further restatement of SRI s financial results for any period. The settlement covers only SRI and Messrs. Peterson and Boosales and remains subject to the completion of settlement documentation and Commission authorization. See Business--Certain Considerations--Pending SEC Investigation.

Class Action Litigation. On January 16, 2003, the Company entered into a Memorandum of Understanding for the settlement and release of claims against the Company and certain former officers that were asserted in a Consolidated Amended Class Action Complaint filed on June 4, 2002, in the United States District Court for the Middle District of Florida. This litigation is a consolidation of substantially similar shareholders lawsuits filed against the Company and certain of its former officers beginning on November 30, 2001, following its restatement of its financial results for the 2001 third quarter. The actions claim violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated under that act, alleging among other things, that during the class period the Company and individual defendants made materially false statements regarding the Company s financial condition and its future prospects. The total settlement amount is $1,900,000, all of which will be covered by the Company s insurer. The settlement remains subject to court approval. No accruals for damages were recorded for this matter as of December 31, 2002 and 2001.

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

No matters were submitted to a vote of security holders during the fourth quarter of 2002.

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PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

The Company s Common Stock trades publicly on The Nasdaq National Market tier of the Nasdaq Stock Market under the symbol STRC. The table below sets forth the high and low bid quotations for the Company s Common Stock from January 1, 2001 through December 31, 2002. These bid prices represent prices between dealers without adjustment for retail mark-ups, mark-downs, or commissions and may not necessarily represent actual transactions.

COMMON STOCK PRICE RANGE

	HIGH	LOW
2001		
First Quarter	$ 20.375	$ 12.500
Second Quarter	$ 36.500	$ 18.625
Third Quarter	$ 41.910	$ 26.000
Fourth Quarter	$ 36.560	$ 11.650
2002		