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ATRION CORP  
Form 10-Q  
November 07, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q

Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended September 30, 2006

or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from to

Commission File Number 0-10763

Atrion Corporation  
(Exact Name of Registrant as Specified in its Charter)

Delaware

63-0821819

-----  
(State or Other Jurisdiction of  
Incorporation or Organization)

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

One Allentown Parkway, Allen, Texas 75002  
(Address of Principal Executive Offices) (Zip Code)

(972) 390-9800  
(Registrant's Telephone Number, Including Area Code)

Indicate by check 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 whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

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

Title of Each Class	Number of Shares Outstanding at November 1, 2006
----- Common stock, Par Value \$0.10 per share	----- 1,871,057

ATRION CORPORATION AND SUBSIDIARIES

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Item 1. Financial Statements

ATRION CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

	Three Months Ended September 30,		Nine Se
	2006	2005	2006
	(in thousands, except per share am		
Revenues	\$ 19,290	\$ 18,338	\$ 59,641
Cost of goods sold	11,803	11,377	36,033
Gross profit	7,487	6,961	23,608
Operating expenses:			
Selling	1,415	1,378	4,631
General and administrative	2,190	1,925	6,541
Research and development	696	547	2,072
	4,301	3,850	13,244
Operating income	3,186	3,111	10,364
Other income:			
Interest income	5	7	26
Interest expense	(58)	(18)	(58)
Other income (expense), net	(4)	2	(26)
	(57)	(9)	(58)
Income from continuing operations before provision for income taxes	3,129	3,102	10,306
Provision for income taxes	(433)	(861)	(2,685)
Income from continuing operations	2,696	2,241	7,621
Gain on disposal of discontinued operations, net of income taxes	--	--	165
Net income	\$ 2,696	\$ 2,241	\$ 7,786
Income per basic share:			
Income from continuing operations	\$ 1.45	\$ 1.23	\$ 4.13
Gain on disposal of discontinued operations	--	--	0.09
	\$ 1.45	\$ 1.23	\$ 4.22
Weighted average basic shares outstanding	1,858	1,829	1,846
Income per diluted share:			
Income from continuing operations	\$ 1.38	\$ 1.15	\$ 3.91
Gain on disposal of discontinued operations	--	--	0.08

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	\$ 1.38	\$ 1.15	\$ 3.99
Weighted average diluted shares outstanding	1,960	1,953	1,951
Dividends per common share	\$ 0.20	\$ 0.17	\$ 0.54

The accompanying notes are an integral part of these statements.

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ATRION CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(in thousands)

Assets	September, 30 2006 (unaudited)	December 31, 2005
-----	-----	----
Current assets:		
Cash and cash equivalents	\$ 234	\$ 525
Accounts receivable	9,541	8,291
Inventories	18,278	17,705
Prepaid expenses	1,053	832
Other	620	620
	-----	-----
	29,726	27,973
	-----	-----
Property, plant and equipment	81,114	63,041
Less accumulated depreciation and amortization	30,621	27,787
	-----	-----
	50,493	35,254
	-----	-----
Other assets and deferred charges:		
Patents	2,341	2,331
Goodwill	9,730	9,730
Other	3,031	3,182
	-----	-----
	15,102	15,243
	-----	-----
	\$ 95,321	\$ 78,470
	=====	=====
Liabilities and Stockholders' Equity		
-----		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 8,096	\$ 7,128
Accrued income and other taxes	712	1,098
	-----	-----
	8,808	8,226

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	-----	-----
Line of credit	11,647	2,529
Other non-current liabilities	6,030	5,820
Stockholders' equity:		
Common shares, par value \$0.10 per share; authorized 10,000 shares, issued 3,420 shares	342	342
Paid-in capital	13,853	12,508
Retained earnings	89,104	82,318
Treasury shares, 1,559 at September 30, 2006 and 1,586 at December 31, 2005, at cost	(34,463)	(33,273)
	-----	-----
	68,836	61,895
	-----	-----
	\$ 95,321	\$ 78,470
	=====	=====

The accompanying notes are an integral part of these statements.

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ATRION CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Nine Months September
	----- 2006 -----
Cash flows from operating activities:	
Net income	\$ 7,786
Adjustments to reconcile net income to net cash provided by operating activities:	
Gain on disposal of discontinued operations	(165)
Depreciation and amortization	3,555
Deferred income taxes	179
Tax benefit related to stock options	--
Stock based compensation expense	61
Other	33
	----- 11,449
Changes in operating assets and liabilities:	
Accounts receivable	(1,250)
Inventories	(573)
Prepaid expenses	(221)

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Other non-current assets	(99)
Accounts payable and accrued liabilities	968
Accrued income and other taxes	(386)
Other non-current liabilities	31
	-----
Net cash provided by continuing operations	9,919
Net cash provided by discontinued operations	165
	-----
	10,084
	-----
Cash flows from investing activities:	
Property, plant and equipment additions	(18,589)
Deposit on land purchase	--
Property, plant and equipment sales	3
	-----
	(18,586)
	-----
Cash flows from financing activities:	
Net change in line of credit	9,118
Exercise of stock options	1,029
Purchase of treasury stock	(1,594)
Tax benefit related to stock options	658
Dividends paid	(1,000)
	-----
	8,211
	-----
Net change in cash and cash equivalents	(291)
Cash and cash equivalents at beginning of period	525
	-----
Cash and cash equivalents at end of period	\$ 234
	=====
Cash paid for:	
Interest (net of capitalization)	\$ 58
Income taxes	\$ 2,552

The accompanying notes are an integral part of these statements.

ATRION CORPORATION AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

- (1) Basis of Presentation  
 In the opinion of management, all adjustments necessary for a fair presentation of results of operations for the periods presented have been included in the accompanying unaudited consolidated financial statements of Atrion Corporation and its subsidiaries (the "Company"). Such adjustments consist of normal recurring items. The accompanying financial statements have been prepared in accordance with the

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instructions to Form 10-Q and include the information and notes required by such instructions. Accordingly, the consolidated financial statements and notes thereto should be read in conjunction with the financial statements and notes included in the Company's 2005 Annual Report on Form 10-K.

(2) Inventories

Inventories are stated at the lower of cost or market. Cost is determined by using the first-in, first-out method. The following table details the major components of inventories (in thousands):

		September 30, 2006		December 31, 2005
Raw materials	\$	7,528	\$	6,898
Work in process		4,178		4,291
Finished goods		6,572		6,516
<b>Total inventories</b>	<b>\$</b>	<b>18,278</b>	<b>\$</b>	<b>17,705</b>

(3) Income per share

The following is the computation for basic and diluted income per share:

	Three months ended September 30, 2006			Nine S 2006
	September 30, 2006		2005	2006
	(in thousands, except per share)			
Income from continuing operations	\$	2,696	\$	2,241
Weighted average basic shares outstanding		1,858		1,829
Add: Effect of dilutive securities (options and restricted stock)		102		124
Weighted average diluted shares outstanding		1,960		1,953
Earnings per share from continuing operations:				
Basic	\$	1.45	\$	1.23
Diluted	\$	1.38	\$	1.15

There were no outstanding options to purchase shares of common stock that were not included in the diluted income per share calculations because their effect would be anti-dilutive for the three-month and nine-month periods ended September 30, 2006 and 2005.

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ATRION CORPORATION AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

(4) Stock-Based Compensation

At September 30, 2006, the Company had three stock-based employee compensation plans. Prior to January 1, 2006, the Company accounted for those plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. No stock-based employee compensation cost was reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The Company recorded compensation expense in the amount of approximately \$37,000 for the three-month period and \$61,000 for the nine-month period ended September 30, 2006. The Company recognized tax benefits related to compensation expense of approximately \$13,000 for the three-month period and \$14,000 for the nine-month period ended September 30, 2006.

Effective January 1, 2006, the Company adopted the provisions of SFAS No. 123R, "Accounting for Stock-based Compensation" ("SFAS No. 123R") using the modified-prospective transition method and the disclosures that follow are based on applying SFAS No. 123R. Under this transition method, compensation expense recognized during the three and nine months ended September 30, 2006, included compensation expense for all share-based awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, "Accounting for Stock-Based Compensation". In accordance with the modified-prospective transition method, results for the prior periods have not been restated.

As a result of the adoption of SFAS No. 123R, the financial results of the Company were lower than the results would have been under the previous accounting method for stock-based compensation by the following amounts:

	Nine months ended September 30, 2006 (in thousands, except per share amounts)
	-----
Income from continuing operations before income taxes	\$ 43
	=====
Income from continuing operations and net income	\$ 35
	=====
Basic and diluted earnings per share	\$.02
	=====

Prior to the adoption of SFAS No. 123R all tax benefits resulting from the exercise of stock options were reflected as operating cash flows in the Consolidated Statements of Cash Flows. SFAS No. 123R requires that cash flows from the exercise of stock-based compensation resulting from tax benefits in excess of recognized compensation cost (excess tax benefits) be classified as financing cash flows. For the nine months



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ended September 30, 2006, \$658,000 of such excess tax benefits was classified as financing cash flows. For the nine months ended September 30, 2005, \$1,180,000 of such excess tax benefits were recorded as operating cash flows, as was prescribed prior to the adoption of SFAS No. 123R.

The Company's 1997 Stock Incentive Plan provides for the grant to key employees of incentive and nonqualified stock options, stock appreciation rights, restricted stock and performance shares. In addition, under the 1997 Stock Incentive Plan, outside directors (directors who are not employees of the Company or any subsidiary) received automatic annual grants of nonqualified stock options to purchase 2,000 shares of common stock. The 1997 Stock Incentive Plan was amended in 2005 to provide that no additional stock options may be granted to outside directors thereunder. Under the 1997 Stock Incentive Plan, 624,425 shares, in the aggregate, of common stock were reserved for grants. The purchase price of shares issued on the exercise of incentive options must be at least equal to the fair market value of such shares on the date of grant. The purchase price for shares issued on the exercise of nonqualified options and restricted and performance shares is fixed by the Compensation Committee of the Board of Directors. The options granted become exercisable as determined by the Compensation Committee and expire no later than 10 years after the date of grant.

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### ATRION CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

During 1998, the Company's stockholders approved the adoption of the Company's 1998 Outside Directors Stock Option Plan which, as amended, provided for the automatic grant on February 1, 1998 and February 1, 1999 of nonqualified stock options to the Company's outside directors. Although no additional options may be granted under the 1998 Outside Directors Stock Option Plan, all outstanding options under this plan continue to be governed by the terms and conditions of the plan and the existing option agreements for those grants.

During 2006, the Company's stockholders approved the adoption of the Company's 2006 Equity Incentive Plan which provides for the grant to key employees and consultants of incentive and nonqualified stock options, restricted stock, restricted stock units, deferred stock units, stock appreciation rights and performance shares. Under the 2006 Equity Incentive Plan, 100,000 shares, in the aggregate, of common stock were reserved for awards. The purchase price of shares issued on the exercise of options must be at least equal to the fair market value of such shares on the date of grant. The purchase price for restricted and performance shares is fixed by the Compensation Committee of the Board of Directors. The options granted become exercisable and expire as determined by the Compensation Committee except that incentive options expire no later than 10 years after the date of grant.

Option transactions for the three and nine months ended September 30, 2006 are as follows:

Three months ended

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September 30, 2006  
-----

	Shares	Weighted Average Exercise Price	Sh
	-----	-----	-----
Options outstanding at the beginning of the period	176,051	\$ 25.64	
Granted	25,000	\$ 71.86	
Expired	-	\$ -	
Exercised	(3,751)	\$ 21.59	
	-----		
Options outstanding at the end of the period	197,300	\$ 31.57	
	=====		=====

Exercisable options at September 30, 2006

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ATRION CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Shares of restricted stock have been awarded to certain key employees. Restrictions lapse as the shares vest, generally over five years. During the vesting period, holders of the restricted stock have voting rights and earn dividends, but the shares may not be sold, assigned, transferred, pledged or otherwise encumbered. Nonvested shares are forfeited on termination of employment. Changes in restricted stock for the three and nine months ended September 30, 2006 were as follows:

	Three months ended September 30, 2006		N
	Shares	Weighted Average Award Date Fair Value	S
	-----	-----	-----
Nonvested shares at the beginning of the period	-	\$ -	-
Awarded	7,500	\$ 71.86	7,500
Vested	-	\$ -	-
Forfeited	-	\$ -	-
	-----		-----
Nonvested shares at the end of the period	7,500	\$ 71.86	7,500
	=====		=====

The Company estimates the fair value of stock options granted using the Black-Scholes option-pricing formula and a single option award

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approach. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. The expected life represents the period that the Company's stock-based awards are expected to be outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior. Stock-based payments made prior to January 1, 2006 were accounted for using the intrinsic value method under APB 25. The fair value of stock-based payments made subsequent to January 1, 2006 are valued using the Black-Scholes valuation method with a volatility factor based on the Company's historical stock trading history. The Company bases the risk-free interest rate using the Black-Scholes valuation method on the implied yield currently available on U. S. Treasury securities with an equivalent term. The Company bases the dividend yield used in the Black-Scholes valuation method on the Company's stock dividend history.

The weighted average grant date fair value of options granted for the three months and nine months ended September 30, 2006 were \$18.02 and \$18.02, respectively.

The total intrinsic value of options exercised during the three and nine months ended September 30, 2006 was \$0. The total intrinsic values of options outstanding and options currently exercisable at September 30, 2006 were \$0 and \$0, respectively. The weighted-average remaining contractual life for options outstanding and options currently exercisable at September 30, 2006 was 2.89 and 2.60 years, respectively. The total intrinsic value of restricted stock grants at September 30, 2006 was \$539,000. The weighted-average remaining contractual term for restricted stock awards at September 30, 2006 was 4.8 years.

As of September 30, 2006 there was \$432,000 in unrecognized compensation cost related to nonvested stock options granted under the plans and \$521,000 in unrecognized compensation cost related to nonvested restricted stock grants. The unrecognized compensation costs related to nonvested stock options will be recognized over a period of 3.8 years. The unrecognized compensation cost related to nonvested stock awards will be recognized over a period of 4.8 years. The total fair value of options vested during the three months ended September 30, 2006 was \$0. At September 30, 2006 there were 25,000 nonvested stock options and 7,500 shares of nonvested restricted stock.

The Company has a policy of utilizing existing treasury shares to satisfy stock option exercises and restricted stock awards.

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### ATRION CORPORATION AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

The following table illustrates the effect on net income and income per share if the Company had applied the fair value recognition provisions of SFAS No. 123R to stock-based employee compensation in the 2005 periods (in thousands, except per share amounts):

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	Three Months ended September 30, 2005
	-----
Net income, as reported	\$ 2,241
Deduct: Total stock-based employee compensation expense determined under fair value-based methods for all awards, net of tax effects	10
	-----
Pro forma net income	\$ 2,231
	=====
Income per share:	
Basic - as reported	\$ 1.23
	=====
Basic - pro forma	\$ 1.22
	=====
Diluted - as reported	\$ 1.15
	=====
Diluted - pro forma	\$ 1.14
	=====

(5) Pension Benefits

The components of net periodic pension cost are as follows for the three and nine months ended September 30, 2006 and September 30, 2005 (in thousands):

	Three Months ended September 30,		
	2006	2005	
	-----	-----	-----
Service cost	\$ 69	\$ 67	\$
Interest cost	83	80	
Expected return on assets	(111)	(114)	
Prior service cost amortization	(9)	(9)	
Actuarial loss	29	27	
Transition amount amortization	-	(11)	
	-----	-----	-----
Net periodic pension cost	\$ 61	\$ 40	\$
	=====	=====	=====

ATRION CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

In 2006, the Company expects to contribute approximately \$250,000 to its pension plan to satisfy minimum funding requirements for the year. As of September 30, 2006, contributions of \$250,000 have been made to this plan.

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(6) Recent Accounting Pronouncements  
In June 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" ("FIN 48"), which clarifies the accounting for uncertainty in income taxes recognized in financial statements. FIN 48 requires the impact of a tax position to be recognized in the financial statements if that position is more likely than not of being sustained by the taxing authority. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the requirements of FIN 48.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)" ("SFAS 158"). SFAS 158 requires an entity to recognize in its statement of financial position an asset for a defined benefit pension or postretirement plan's overfunded status or a liability for a plan's underfunded status, and to recognize changes in that funded status through other comprehensive income in the year in which the changes occur. SFAS 158 will not change the amount of net periodic benefit expense recognized in an entity's results of operations. SFAS 158 is effective for fiscal years ending after December 15, 2006. The Company is currently evaluating the requirements of SFAS 158.

On September 13, 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company does not expect the adoption of SAB No. 108 to have a material impact on its consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"), which provides guidance for measuring the fair value of assets and liabilities, as well as requires expanded disclosures about fair value measurements. SFAS 157 indicates that fair value should be determined based on the assumptions marketplace participants would use in pricing the asset or liability, and provides additional guidelines to consider in determining the market-based measurement. The Company will be required to adopt SFAS 157 on January 1, 2008. The Company is currently evaluating the impact of adopting SFAS 157 on its Consolidated Financial Statements.

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### Overview

The Company designs, develops, manufactures, sells and distributes products and components, primarily for the medical and healthcare industry. The Company markets components to other equipment manufacturers for incorporation in their products and sells finished devices to physicians, hospitals, clinics and other treatment centers. The Company's medical products primarily serve the fluid delivery, cardiovascular, and ophthalmology markets. The Company's other medical and non-medical products include obstetrics products, instrumentation and disposables used in dialysis, contract manufacturing and valves and inflation devices used in marine and aviation safety products.

The Company's products are used in a wide variety of applications by numerous customers. The Company encounters competition in all of its markets and competes primarily on the basis of product quality, price, engineering, customer service and delivery time.

The Company's strategy is to provide a broad selection of products in the areas of its expertise. Research and development efforts are focused on improving current products and developing highly-engineered products that meet customer needs and have the potential for broad market applications and significant sales. Proposed new products may be subject to regulatory clearance or approval prior to commercialization and the time period for introducing a new product to the marketplace can be unpredictable. The Company also focuses on controlling costs by investing in modern manufacturing technologies and controlling purchasing processes. The Company has been successful in consistently generating cash from operations and has used that cash to reduce indebtedness, to fund capital expenditures, to repurchase stock and, starting in 2003, to pay dividends.

The Company's strategic objective is to further enhance its position in its served markets by:

- o Focusing on customer needs;
- o Expanding existing product lines and developing new products;
- o Maintaining a culture of controlling cost; and
- o Preserving and fostering a collaborative, entrepreneurial management structure.

For the three months ended September 30, 2006, the Company reported revenues of \$19.3 million, operating income of \$3.2 million and net income of \$2.7 million, up 5 percent, 2 percent and 20 percent, respectively, from the three months ended September 30, 2005. For the nine months ended September 30, 2006, the Company reported revenues of \$59.6 million, operating income of \$10.4 million and net income of \$7.8 million, up 8 percent, 7 percent and 14 percent, respectively, from the nine months ended September 30, 2005.

During the third quarter of 2006, the Company completed the construction of the new facility for a subsidiary, Halkey-Roberts Corporation ("Halkey-Roberts"). The relocation of the Halkey-Roberts operations to its new facility was substantially completed in the third quarter of 2006.

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Consolidated net income totaled \$2.7 million, or \$1.45 per basic and \$1.38 per diluted share, in the third quarter of 2006. This is compared with consolidated net income of \$2.2 million, or \$1.23 per basic and \$1.15 per diluted share, in the third quarter of 2005. The income per basic share computations are based on weighted average basic shares outstanding of 1,858,356 in the 2006 period and 1,828,886 in the 2005 period. The income per diluted share computations are based on weighted average diluted shares outstanding of 1,960,274 in the 2006 period and 1,952,700 in the 2005 period.

Consolidated revenues of \$19.3 million for the third quarter of 2006 were 5 percent higher than revenues of \$18.3 million for the third quarter of 2005. This 5 percent increase in revenues was primarily attributable to an approximate 15 percent increase in the revenues from the Company's fluid delivery products and an approximate 14 percent increase in the revenues from the Company's cardiovascular products. These increases, which were generally attributable to higher sales volumes, were partially offset by an approximate 14 percent decrease in the revenues from the Company's ophthalmic products.

Revenues by product line were as follows (in thousands):

	Three Months ended September 30,		
	2006		
Fluid Delivery	\$	6,121	\$
Cardiovascular		5,707	
Ophthalmology		3,301	
Other		4,161	
Total	\$	19,290	\$
		=====	

Cost of goods sold of \$11.8 million for the third quarter of 2006 was 4 percent higher than in the comparable 2005 period. Increased sales volume and increased manufacturing overhead costs offset by a favorable product mix were the primary contributors to the increase in cost of goods sold for the third quarter of 2006.

Gross profit of \$7.5 million in the third quarter of 2006 was \$526,000, or 8 percent, higher than in the comparable 2005 period. The Company's gross profit percentage in the third quarter of 2006 was 38.8 percent of revenues compared with 38.0 percent of revenues in the third quarter of 2005. The increase in gross profit percentage in the 2006 period compared to the 2005 period was primarily related to improved product mix partially offset by increased manufacturing overhead costs.

The Company's third quarter 2006 operating expenses of \$4.3 million were \$451,000 higher than the operating expenses for the third quarter of 2005, resulting primarily from a \$265,000 increase in General and Administrative (G&A) expenses, a \$37,000 increase in selling (Selling) expenses, and a \$149,000 increase in Research and Development (R&D) expenses. The increase in G&A for the third quarter of 2006 was primarily related to increased outside services and costs associated

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with the relocation to the new facility for Halkey-Roberts. The increase in Selling expenses for the third quarter of 2006 was principally attributable to increased compensation costs and outside services. The increase in R&D costs was primarily related to outside services, prototype expenses, new product testing costs, and process enhancements. Operating income in the third quarter of 2006 increased \$75,000, or 2 percent, to \$3.2 million from \$3.1 million in the third quarter of 2005. Operating income was 16.5 percent of revenues in the third quarter of 2006 compared to 17.0 percent of revenues in the third quarter of 2005. The change in operating income for the third quarter of 2006 as compared with the third quarter of 2005 was primarily attributable to the previously mentioned increased gross profit offset by the increased operating expenses.

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Interest expense of \$58,000 for the 2006 period is greater than the 2005 period primarily related to increased borrowing levels in connection with the construction of the Halkey-Roberts facility. Third quarter 2006 interest charges of \$112,000, through August 31, 2006, were capitalized during the construction phase of the new Halkey-Roberts facility. Income tax expense for the third quarter of 2006 was \$433,000 compared to income tax expense of \$861,000 for the same period in the prior year. The effective tax rate for the third quarter of 2006 was 13.8 percent compared with 27.7 percent for the third quarter of 2005. The lower effective tax rate for the 2006 period is primarily related to a review of the Company's R&D tax credits for 2005 and prior-year tax returns which indicated that the Company was entitled to higher credits than had been claimed.

Results for the nine months ended September 30, 2006

Consolidated net income totaled \$7.8 million, or \$4.22 per basic and \$3.99 per diluted share, for the nine months ended September 30, 2006. This is compared with consolidated net income of \$6.8 million, or \$3.82 per basic and \$3.56 per diluted share, for the nine months ended September 30, 2005. The income per basic share computations are based on weighted average basic shares outstanding of 1,846,265 in the 2006 period and 1,780,822 in the 2005 period. The income per diluted share computations are based on weighted average diluted shares outstanding of 1,951,413 in the 2006 period and 1,915,087 in the 2005 period.

Consolidated revenues of \$59.6 million for the nine months ended September 30, 2006 were 8 percent higher than revenues of \$55.1 million for the nine months ended September 30, 2005. This 8 percent increase in revenues was primarily attributable to an approximate 25 percent increase in the revenues from the Company's fluid delivery products and an approximate 22 percent increase in the revenues from the Company's cardiovascular products. These increases, which were generally attributable to higher sales volumes, were partially offset by an approximate 17 percent decrease in the revenues from the Company's ophthalmic products and an approximate 3 percent decrease in the revenues from the Company's other products.

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Revenues by product line were as follows (in thousands):



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	Nine months September
	----- 2006 -----
Fluid Delivery	\$ 19,180
Cardiovascular	17,147
Ophthalmology	9,685
Other	13,629
	-----
Total	\$59,641 =====

Cost of goods sold of \$36.0 million for the nine months ended September 30, 2006 was 8 percent higher than in the comparable 2005 period. Increased sales volume, increased manufacturing overhead costs, and a temporary production curtailment due to reduced orders from certain ophthalmic and related kitting business customers were the primary contributors to the increase in cost of goods sold for the nine months ended September 30, 2006.

Gross profit of \$23.6 million for the nine months ended September 30, 2006 was \$1.8 million, or 8 percent, higher than in the comparable 2005 period. The Company's gross profit percentage was 39.6 percent of revenues for both the nine months ended September 30, 2006 and 2005.

The Company's third quarter 2006 operating expenses of \$13.2 million were \$1.1 million higher than the operating expenses for the nine months ended September 30, 2005, resulting primarily from a \$400,000 increase in Selling expenses, a \$320,000 increase in R&D expenses and a \$397,000 increase in G&A expenses. The increase in Selling expenses for the nine months ended September 30, 2006 was principally attributable to increased compensation costs, advertising and promotion costs and outside services. The increase in R&D costs was primarily related to outside services, prototype expenses, new product testing costs, and process enhancements. The increase in G&A for the nine months ended September 30, 2006 was primarily related to increased outside services and costs associated with the relocation to the new facility for Halkey-Roberts partially offset by a decrease in insurance costs. Operating income for the nine months ended September 30, 2006 increased \$703,000, or 7 percent, to \$10.4 million from \$9.7 million in the nine months ended September 30, 2005. Operating income was 17.4 percent of revenues for the nine months ended September 30, 2006 compared to 17.5 percent of revenues for the nine months ended September 30, 2005.

Interest expense of \$58,000 for the 2006 period is less than the 2005 period because of the capitalization of interest charges in connection with the construction of the Halkey-Roberts facility. Interest charges of \$326,000, through August 31, 2006, were capitalized during the construction phase of the new Halkey-Roberts facility. Income tax expense for the nine months ended September 30, 2006 was \$2.7 million compared to income tax expense of \$3.0 million for the same period in the prior year. The effective tax rate for the nine months ended September 30, 2006 was 26.0 percent compared with 31.1 percent for the nine months ended September 30, 2005. The lower effective tax rate for the 2006 period is primarily related to a review of the Company's R&D

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tax credits for 2005 and prior-year tax returns which indicated that the Company was entitled to higher credits than had been claimed.

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The Company recorded a gain on the disposal of discontinued operations relating to the 1997 sale of its natural gas operations of \$165,000 after tax, or \$0.09 per basic and \$0.08 per diluted share, for the first nine months of 2006 and \$165,000 after tax, or \$0.09 per basic and \$0.09 per diluted share, for the first nine months of 2005, resulting from the receipt of contingent deferred payments in each year. No additional payments are due in future periods under the terms of the 1997 agreement pursuant to which the Company sold its natural gas operations.

### Liquidity and Capital Resources

At September 30, 2006, the Company had cash and cash equivalents of \$234,000 compared with \$525,000 at December 31, 2005. The Company had outstanding borrowings of \$11.6 million under its \$25.0 million revolving credit facility ("Credit Facility") at September 30, 2006 and \$2.5 million at December 31, 2005. The increase in the outstanding balance under the Credit Facility in the first nine months of 2006 was primarily attributable to borrowings to partially fund the construction of the new Halkey-Roberts facility. The Credit Facility, which expires November 12, 2009, and may be extended under certain circumstances, contains various restrictive covenants, none of which is expected to impact the Company's liquidity or capital resources. At September 30, 2006, the Company was in compliance with all financial covenants.

As of September 30, 2006, the Company had working capital of \$20.9 million, including \$234,000 in cash and cash equivalents. The \$1.2 million increase in working capital during the first nine months of 2006 was primarily related to an increase in accounts receivable and inventories, and a decrease in accrued income and other taxes partially offset by an increase in accounts payable and accrued liabilities. The increase in accounts receivable during the first nine months of 2006 was primarily related to the increase in revenues for the third quarter of 2006 as compared to the fourth quarter of 2005. The increase in inventories is primarily related to increased purchases of raw materials in an effort to realize lower costs due to volume purchasing and increased stocking levels to support increased revenues. The increase in accounts payable is primarily related to the increased raw material purchases. Cash flows from continuing operations generated \$9.9 million for the nine months ended September 30, 2006 as compared to \$6.1 million for the nine months ended September 30, 2005. The 2005 period was heavily impacted by a \$3.1 million increase in inventories. During the first nine months of 2006, the Company expended \$18.6 million for the purchase of property and equipment. Of this amount, approximately \$13.0 million was expended for the construction of the new Halkey-Roberts facility. The Company received net proceeds of \$1.0 million from the exercise of employee stock options during the first nine months of 2006. During the first nine months of 2006, the Company repurchased 24,000 shares of its common stock for approximately \$1.6 million and paid dividends totaling \$1.0 million to its stockholders.

The Company believes that its existing cash and cash equivalents, cash flows from operations, borrowings available under the Company's credit facility, supplemented, if necessary, with equity or debt financing, which the Company believes would be available, will be sufficient to fund the Company's cash requirements for the foreseeable future.

#### Forward-Looking Statements

The statements in this Management's Discussion and Analysis that are forward-looking are based upon current expectations, and actual results may differ materially. Therefore, the inclusion of such forward-looking information should not be regarded as a representation by the Company that the objectives or plans of the Company would be achieved. Such statements include, but are not limited to, the Company's expectations regarding future liquidity and capital resources. Words such as "anticipates," "believes," "expects," "estimated" and variations of such words and similar expressions are intended to identify such forward-looking statements. Forward-looking statements contained herein involve numerous risks and uncertainties, and there are a number of factors that could cause actual results or future events to differ materially, including, but not limited to, the following: changing economic, market and business conditions; acts of war or terrorism; the effects of governmental regulation; the impact of competition and new technologies; slower-than-anticipated introduction of new products or implementation of marketing strategies; implementation of new manufacturing processes or implementation of new information systems; the Company's ability to protect its intellectual property; changes in the prices of raw materials; changes in product mix; intellectual property and product liability claims and product recalls; the ability to attract and retain qualified personnel; the loss of, or any material reduction in sales to, any significant customers. In addition, assumptions relating to budgeting, marketing, product development and other management decisions are subjective in many respects and thus susceptible to interpretations and periodic review which may cause the Company to alter its marketing, capital expenditures or other budgets, which in turn may affect the Company's results of operations and financial condition.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

For the quarter ended September 30, 2006, the Company did not experience any material changes in market risk exposures that affect the quantitative and qualitative disclosures presented in the Company's 2005 Annual Report on Form 10K.

#### Item 4. Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and its Chief Financial Officer, evaluated the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of September 30, 2006. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting for the quarter ended September 30, 2006 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

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PART II

OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

10.1 Chief Executive Officer Amended and Restated Employment Agreement

31.1 Sarbanes-Oxley Act Section 302 Certification of Chief Executive Officer

31.2 Sarbanes-Oxley Act Section 302 Certification of Chief Financial Officer

32.1 Certification Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of The Sarbanes - Oxley Act Of 2002

32.2 Certification Pursuant To 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of The Sarbanes - Oxley Act Of 2002

(b) Reports on Form 8-K

On August 8, 2006, the Company filed a report on Form 8-K with the SEC regarding the public dissemination of a press release announcing its financial results for the second quarter ended June 30, 2006 (Item 12).

On August 10, 2006, the Company filed a report on Form 8-K with the SEC regarding an amendment to the existing employment agreement dated January 1, 2002 and amended on December 3, 2002 between the Company and the Company's Chairman, President and Chief Executive Officer and the adoption of a Rights Plan.

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SIGNATURES

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

Atrion Corporation  
(Registrant)

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Date: November 6, 2006

/s/ Emile A. Battat

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Emile A. Battat  
Chairman, President and  
Chief Executive Officer

Date: November 6, 2006

/s/ Jeffery Strickland

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Jeffery Strickland  
Vice President and  
Chief Financial Officer