CHAD THERAPEUTICS INC
Form 10-Q
August 14, 2008

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

þ **Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For Quarterly Period Ended: June 30, 2008**
**Or**

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**Commission file number: 1-12214**
**CHAD THERAPEUTICS, INC.**

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| California | 95-3792700 |
| (State of other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

10200 Mason Avenue, Suite 114, Chatsworth, CA 91311

(Address of principal executive offices) (Zip Code)
(818) 882-0883

(Registrant s telephone number, including area code)
21622 Plummer Street, Chatsworth, CA 91311

(Former Address)
(Former name, former address and former fiscal year, if changed since last report.)

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 þ No o

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

| | | | |
|---|---|---|---|
| Large accelerated filer o | Accelerated filer o | Non-accelerated filer o (Do not check if a smaller reporting company) | Smaller reporting company þ |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ
As of June 30, 2008, the registrant had 10,180,000 shares of its common stock outstanding.

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CHAD THERAPEUTICS, INC.
Balance Sheets
June 30, 2008 and March 31, 2008
(Unaudited)

| | June 30, 2008 | March 31, 2008 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash | $ 683,000 | $ 2,068,000 |
| Accounts receivable, less allowance for doubtful accounts of $28,000 at June 30, 2008 and $166,000 and March 31, 2008 | 103,000 | 526,000 |
| Prepaid expenses and other assets | 89,000 | 127,000 |
| Total current assets | 875,000 | 2,721,000 |
| Property and equipment, at cost | 65,000 | 65,000 |
| Less accumulated depreciation | 33,000 | 30,000 |
| Net property and equipment | 32,000 | 35,000 |
| Intangible assets, net | 776,000 | 761,000 |
| Other assets | 32,000 | 25,000 |
| Total assets | $ 1,715,000 | $ 3,542,000 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 74,000 | $ 95,000 |
| Accrued expenses | 1,049,000 | 2,274,000 |
| Total current liabilities | 1,123,000 | 2,369,000 |
| Commitments and contingencies (Note 12) | | |
| Shareholders equity: | | |
| Common shares, $.01 par value, authorized 40,000,000 shares; 10,180,000 and 10,180,000 shares issued and outstanding | 14,208,000 | 14,208,000 |
| Accumulated deficit | (13,616,000) | (13,035,000) |
| Total shareholders equity | 592,000 | 1,173,000 |
| Total liabilities and shareholders equity | $ 1,715,000 | $ 3,542,000 |

See accompanying notes to financial statements.

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CHAD THERAPEUTICS, INC.
Statements of Operations
For the three months ended June 30, 2008 and 2007

| | Three Months Ended June 30, 2008 | Three Months Ended June 30, 2007 |
|---|---|---|
| Costs and expenses: | | |
| Selling, general, and administrative | $ 403,000 | $ 647,000 |
| Research and development | 208,000 | 224,000 |
| Costs and expenses from continuing operations | 611,000 | 871,000 |
| Other income | 30,000 | |
| Interest Expense | | 22,000 |
| Loss from continuing operations before income tax expense | (581,000) | (893,000) |
| Income tax expense | | 4,000 |
| Net loss from continuing operations | (581,000) | (897,000) |
| Discontinued operations (Note 2) | | |
| Earnings (Loss) from discontinued operations | | (393,000) |
| Net loss | $ (581,000) | $ (1,290,000) |
| Basic and diluted loss per share, continuing operations | $ (0.06) | $ (0.09) |
| Basic and diluted loss per share, discontinued operations | $ | $ (0.04) |
| Total basic and diluted loss per share | $ (0.06) | $ (0.13) |
| Weighted shares outstanding: | | |
| Basic | 10,180,000 | 10,180,000 |
| Diluted | 10,180,000 | 10,180,000 |

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CHAD THERAPEUTICS, INC.
Condensed Statement of Shareholders Equity
For the three months ended June 30, 2008
(Unaudited)

| | Common Shares | | Accumulated |
|---|---|---|---|
| | Shares | Amount | Deficit |
| Balance as of March 31, 2008 | 10,180,000 | 14,208,000 | $ (13,035,000) |
| Net loss | | | (581,000) |
| Balance at June 30, 2008 | 10,180,000 | 14,208,000 | $ (13,616,000) |

See accompanying notes to condensed financial statements.

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CHAD Therapeutics, Inc.
Condensed Statement of Cash Flows
For the three months ended June 30, 2008 and 2007

| | Three Months Ended June, | |
|---|---|---|
| | 2008 | 2007 |
| Cash flows from operating activities: | | |
| Net loss | $ (581,000) | $ (1,290,000) |
| Adjustments to reconcile net loss to net cash (used in) provided by operating activities: | | |
| Depreciation and amortization of property and equipment | 3,000 | 77,000 |
| Amortization of intangibles | 7,000 | 59,000 |
| Provision for losses on receivables | (138,000) | (1,000) |
| Stock-based compensation | | 4,000 |
| Changes in assets and liabilities: | | |
| Decrease (increase) in accounts receivable | 561,000 | 895,000 |
| Decrease (increase) in inventories | | 687,000 |
| Decrease (increase) in prepaid expenses and other assets | 31,000 | 33,000 |
| Increase (decrease) in accounts payable | (21,000) | (551,000) |
| Increase (decrease) in accrued expenses | (1,225,000) | 18,000 |
| Net cash used in operating activities | (1,363,000) | (69,000) |
| Cash flows from investing activities: | | |
| Additions to intangible assets | (22,000) | (25,000) |
| Capital expenditures | | (20,000) |
| Net cash used in investing activities | (22,000) | (45,000) |
| Net increase (decrease) in cash | (1,385,000) | (114,000) |
| Cash beginning of period | 2,068,000 | 375,000 |
| Cash end of period | $ 683,000 | $ 261,000 |

See accompanying notes to condensed financial statements.

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**CHAD THERAPEUTICS, INC.**
**NOTES TO CONDENSED FINANCIAL STATEMENTS**
**(Unaudited)**

1. Basis of Presentation and Going Concern

CHAD Therapeutics, Inc. (the Company ) is now working exclusively on the development and commercialization of diagnostic and therapeutic devices for the sleep disorder market. In February and March 2008, the Company sold all of its oxygen product assets, in two separate transactions, and exited the oxygen market entirely. The Company closed its production facilities located in Chatsworth, California in June 2008, and there will be no further costs or revenues associated with its former oxygen product line. The Company is currently developing diagnostic and therapeutic products for the sleep disorder market. It received 510k clearance for its first product in July 2008. Currently, the Company is not generating revenues from any of the sleep products it has under development.

In the opinion of management, all adjustments necessary, which are of a normal and recurring nature, for a fair presentation of the results for the interim periods presented, have been made. The results for the three-month period ended June 30, 2008, are not necessarily indicative of the results expected for the year ended March 31, 2009. The interim statements are condensed and do not include some of the information necessary for a more complete understanding of the financial data. Accordingly, your attention is directed to the footnote disclosures found in the March 31, 2008, Annual Report and particularly to Note 1 which includes a summary of significant accounting policies.

The Company s financial statements have been prepared and presented on a basis assuming it will continue as a going concern. However, the Company s prospects must be considered in light of substantial risks. The Company has experienced net losses since its fiscal year ended March 31, 2006 and as of June 30, 2008, it had an accumulated deficit of approximately $13,616,000. For the three-months ended June 30, 2008, the Company had a net loss of $581,000 and utilized approximately $1,363,000 of cash in operating activities. The Company expects operating losses to continue through its foreseeable future as the sleep products do not yet generate revenue. The Company is in need of additional financing or a strategic arrangement in order to continue operations. These factors, amongst others, raise substantial doubts about the Company s ability to continue as a going concern.

On November 16, 2007, the Company entered into a definitive agreement, subject to shareholder approval, to sell to Inovo, Inc. (the Buyer ) substantially all of the assets of the Company related to the oxygen conserver business including accounts receivable, inventory, and certain equipment and intellectual property (the Asset Sale ) pursuant to an Asset Purchase Agreement (the APA ). Pursuant to the APA, the Buyer assumed certain liabilities and obligations related to the Company s oxygen conserver business. The Company s shareholders voted to approve the sale of the Company s oxygen conserver business on January 31, 2008 and the Asset Sale was completed for $5,250,000 on February 15, 2008. On March 6, 2008, the Company entered into an Asset Purchase Agreement (the Purchase Agreement ) with Respironics, Inc., ( Respironics ). Pursuant to the Purchase Agreement, Respironics acquired the Company s assets related to the transfilling oxygen business, the Total O2

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Delivery System, including the OMNI-5 In-Home Filling System, OMNI-2 In-Home Filling System, Omni Fill technology and the Company s Post Valve patent for the purchase price of $1.825 million. Under the terms of the Purchase Agreement, Respironics assumed certain liabilities and obligations related to the Company s transfilling oxygen business and the Company agreed to indemnify Respironics for expenses arising out of any breach of its representations or warranties. As a result of the discontinued operations presentation, the net earnings (loss) related to the discontinued operations of $(393,000) for the three months ended June 30, 2007, has been presented in the Statements of Operations as a component of earnings (loss) from discontinued operations.

During the next twelve months, the Company intends to seek outside financing arrangements in order to facilitate its ability to fund anticipated capital expenditures, support its development of the sleep products, and enhance its working capital resources. Financing may be obtained through the sale of equity or debt securities, through the establishment of credit arrangements or through some combination of the foregoing. The Company has no established lines of credit or other arrangements in place to obtain working capital, and no assurance can be given regarding if and when other sources of working capital would be available. Moreover, the Company does not currently have in place any arrangements to raise additional funds through the sale of securities and it is not possible at this time to predict the terms upon which securities might be sold, or if the Company can raise any funds from prospective investors.

2. Discontinued Operations

A protracted period of reductions in reimbursement for home respiratory care and continuing uncertainty with respect to future prospects for an adequate reimbursement regime caused the Company to make the decision to exit the oxygen business. In February and March 2008, the Company exited the oxygen therapy business by selling all of its oxygen assets in two separate transactions. On November 16, 2007, the Company entered into a definitive agreement, subject to shareholder approval, to sell to Inovo, Inc. (the Buyer ) substantially all of the assets of the Company related to the oxygen conserver business including accounts receivable, inventory, and certain equipment and intellectual property (the Asset Sale ) pursuant to an Asset Purchase Agreement (the APA ). Pursuant to the APA, the Buyer would assume certain liabilities and obligations related to the Company s oxygen conserver business. The Company s shareholders voted to approve the sale of the Company s oxygen conserver business on January 31, 2008 and the Asset Sale was completed for $5,250,000 on February 15, 2008. On March 6, 2008, the Company entered into an Asset Purchase Agreement (the Purchase Agreement ) with Respironics, Inc., ( Respironics ). Pursuant to the Purchase Agreement, Respironics acquired the Company s assets related to the transfilling oxygen business, the Total O2 Delivery System, including the OMNI-5 In-Home Filling System, OMNI-2 In-Home Filling System, Omni Fill technology and the Company s Post Valve patent for the purchase price of $1,825,000. Under the terms of the Purchase Agreement, Respironics assumed certain liabilities and obligations related to the Company s transfilling oxygen business and the Company agreed to indemnify Respironics for expenses arising out of any breach of its representations or warranties. As a result of the discontinued operations presentation, the net earnings (loss) related to the

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discontinued operations have been presented in the Statements of Operations as a component of earnings (loss) from discontinued operations.

In accordance with provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, it was determined that the oxygen therapy business should be presented as a discontinued operation in the financial statements.

The following results of the oxygen business have been presented as earnings (loss) from discontinued operations in the accompanying statements of operations:

| | 2008 | 2007 |
|---|---|---|
| Net sales | $ | $ 3,973,000 |
| Cost of sales | | 3,178,000 |
| Gross profit | | 795,000 |
| Operating expenses | | 1,141,000 |
| Other expenses | | 47,000 |
| Earnings (loss) from discontinued operations | $ | $ (393,000) |

3. Revenue Recognition

Revenue from product sales is recognized upon shipment of merchandise when title and risk of loss transfers to the customer and the earnings process is complete. Products are shipped FOB shipping point and title to the products transfers to the purchaser upon shipment. Under a sales-type lease agreement, revenue is recognized at the time of the shipment with interest income recognized over the life of the lease. Shipping charges billed to customers are included in net sales. Allowances for customer returns have not been established, as historically customer return experience has been minor. Costs paid to shipping companies are recorded as a cost of sales.

4. Major Customers

| | Three Months Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Customer A** | * | 47.7% |

* Indicates sales less than 10% of the Company s Net Sales balance

** Indicates national chain customer

5. Concentration of Credit Risk

At times the Company maintains balances of cash that exceed $100,000 per financial institution, the maximum insured by the Federal Deposit Insurance Corporation. Further, the Company maintains a portion of its cash funds in an interest bearing, uninsured account. The Company s right to the cash is subject to the risk that the financial institution will not pay when cash is requested. The potential loss is the amount in any one financial institution over $100,000 and/or all funds in the interest bearing account. At June 30, 2008, the amount at risk was approximately $142,000.

The significant outstanding accounts receivable balances in 2008 were as follows:

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| | June 30 | March 31 |
|---|---|---|
| Customer A | 41.7% | 47.1% |
| Customer B | * | 20.8% |
| Customer C | 26.1% | * |
| Customer D | 16.6% | * |

* Indicates receivables balance less than 10% of the Company s net accounts receivable balance.

6. Inventories

Due to the sales of its oxygen assets in February and March of 2008, the Company did not have any inventory at June 30, 2008 or March 31, 2008.

7. Long-Term Debt and Revolving Line of Credit

In March 2007, the Company entered into a one-year factoring arrangement that provided for the sale of up to $1,500,000 of the Company s accounts receivable. Assignments under the agreement incurred interest at the bank s prime rate plus two percent (2%) to three percent (3%) depending on the total accounts receivable balance. The Company had a minimum monthly interest payment of $6,000 beginning April 2007. The Company voluntarily terminated the factoring agreement on July 30, 2007.

On July 30, 2007, the Company entered into a financing transaction with Calliope Capital Corporation , a Delaware corporation (the Investor ) pursuant to which the Company issued to the Investor a $750,000 convertible term note ( Convertible Note ) and a $2,750,000 revolving credit line ( Credit Line ), all secured by the Company s assets. The Convertible Note was payable in equal installments over 36 months beginning in November 2007 and maturing in July 2010 and bore interest at prime plus 2%, and the Credit Line bore interest at prime plus 1.5%. A portion of that financing was used to pay all outstanding obligations on the Company s factoring arrangement. At the Investor s option, the Convertible Note could have been converted into shares of the Company s common stock at any time during the term of the note at a conversion price of $1.18. The closing price of the Company s common stock on the issue date of the Convertible Note was $1.00 per share. In addition, warrants to purchase up to 976,744 shares of the Company s common stock were issued to the Investor with an exercise price of $1.24 per share. The Investor was granted registration rights with respect to the shares underlying the warrants. The warrants include a lock-up feature for a period of 12 months after any warrants are exercised. On February 13, 2008, the Company voluntarily terminated both the Convertible Note and the revolving Credit Line. The warrants issued to Calliope Capital Corporation remain outstanding but unexercised at June 30, 2008.

In order to address the Company s limited ability to draw against its Credit Line at the end of the second fiscal quarter, on January 2, 2008, the Company entered a Subordinated Secured Note and Warrant Purchase Agreement (the Credit Facility ) with Mr. Earl Yager and Mr. Thomas Jones, our Chief Executive Officer and our Chairman of the Board, respectively. The Company entered into the financing arrangement after it was unsuccessful in obtaining financing on acceptable terms

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from a third party. The terms of the financing arrangement were negotiated and approved by the Company s independent directors who concluded that the terms were more favorable to the Company than those available from third party lenders. Pursuant to the terms of the Credit Facility, the Company could draw an aggregate of $1,000,000, subject to certain conditions. The Company voluntarily terminated the Credit Facility on February 15, 2008.

In connection with the Credit Facility, Mr. Yager and Mr. Jones each received 321,428 warrants to purchase our common stock at a price per share equal to $0.28 (the average closing price of our common stock on the American Stock Exchange for the five days immediately preceding the initial funding under the Credit Facility). The number of shares issuable for each warrant will be equal to (a) the principal amount of the Note issued at the initial closing multiplied by 0.30, divided by (b) the exercise price. The warrants have a term of five years. No additional warrants are issuable in connection with any additional borrowings the Company may make under the Credit Facility.

8. Income Tax Expense

Based on management s earnings projections for the fiscal year ended 2008, the Company has forecasted an effective tax rate of 35 percent. As of March 31, 2008, the Company has Federal net operating loss carryforwards of approximately $12,000,000 of which $1,459,000 expires in 2027 and the balance in 2028 and California net operating loss carryforwards of approximately $11,000,000 of which $3,442,000 expires in 2013 with the balance expiring in 2014. In assessing the realizability of deferred tax assets, management considered whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. At June 30, 2008, the Company s deferred tax assets are fully offset by a valuation allowance.

9. Geographic Information

The Company has one reportable operating segment. Geographic information regarding the Company s net sales is as follows:

| | Three Months Ended June 30, 2008 | Three Months Ended June 30, 2007 |
|---|---|---|
| United States | $ | $ 3,579,000 |
| Canada | | 35,000 |
| Japan | | 58,000 |
| Europe | | 143,000 |
| All other countries | | 158,000 |
| | $ | $ 3,973,000 |

Sales for the three-months ended June 30, 2007 are solely of the Company s oxygen related products. Due to the sale of the all of the Company s oxygen assets, there will be no further sales of oxygen related products. The Company has not yet brought any of its sleep products to market.

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All long-lived assets are located in the United States.

Sales of OXYMATIC®, LOTUS and CYPRESS OXYPneumatic® conservers and SAGE Therapeutic devices accounted for 70% of the Company s sales for the three-month period ended June 30, 2007.

10. Stock Option Plan

On April 1, 2006, the Company adopted Statement of Financial Accounting Standards 123R, Share-Based Payment, which revised SFAS 123, Accounting for Stock-Based Compensation. The Company adopted FAS 123R using the modified prospective transition method. Previously, the Company had followed APB 25, accounting for employee stock options at intrinsic value. Accordingly, during the three-month period ended June 30, 2007, the Company recorded stock-based compensation expense for awards granted prior to, but not yet vested, as of April 1, 2006, as if the fair value method required for pro forma disclosure under FAS 123 were in effect for expense recognition purposes, adjusted for estimated forfeitures. For stock-based awards granted after April 1, 2006, the Company would recognize compensation expense based on the estimated grant date fair value method using the Black-Scholes valuation model. For these awards, the Company would recognize compensation expense using a straight-line method. As FAS 123R requires that stock based compensation expense be based on awards that are ultimately expected to vest, stock-based compensation for the three-month period ended June 30, 2007, has been reduced for estimated forfeitures. For the three-month period ended June, 2007, stock-based compensation expense of $4,000 was recorded to selling, general, and administrative expenses, all of which was due to FAS 123R option expense. All of the Company s options were fully vested prior to the three-months ended June 30, 2008 so no stock compensation expense was recorded. Due to the prospective adoption of SFAS No. 123R, results for prior period have not been restated.

The Company has an equity incentive plan (the Plan) for key employees as defined under Section 422(A) of the Internal Revenue Code. The Plan provides that 750,000 common shares be reserved for issuance under the Plan, which expires on September 8, 2014, of which approximately 535,000 are available for future grant at June 30, 2008. In addition, the Plan provides that non-qualified options can be granted to directors and independent contractors of the Company. Stock options are granted with an exercise price equal to the market value of a share of the Company s stock on the date of the grant. Historically, grants to non-employee directors have vested over two years, while the majority of grants to employees have vested over two to five years of continuous service.

The fair value of each stock option award is estimated on the date of the grant using the Black-Scholes option valuation model. Expected volatility is based on the historical volatility of the Company s stock. No expected dividend yield is used since the Company has not historically declared or paid dividends and no dividends are expected in the foreseeable future. The risk-free interest rate is based on the U.S. treasury yield curve on the grant date for the expected term of the option. The Company did not grant any stock options during the three months ended June 30, 2008 and 2007, respectively. A summary of stock option activity as of and for the three-months ended June 30, 2008, is presented below:

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| | Shares | Exercise Price Per Share | Remaining Contractual Term (in years) |
|---|---|---|---|
| Outstanding at March 31, 2008 | 844,000 | $ 2.01 | |
| Granted | | | |
| Exercised | | | |
| Forfeited or expired | 139,000 | 2.28 | |
| Outstanding at June 30, 2008 | 705,000 | $ 1.94 | 3.0 |
| As of June 30, 2008: | | | |
| Exercisable | 705,000 | $ 1.94 | 3.0 |
| Vested and expected to vest | 705,000 | $ 1.94 | 3.0 |

No options were granted or exercised during the three-months ended June 30, 2008 or 2007.

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of the Company s common stock at June 30, 2008 for the options that were in-the-money at June 30, 2008. As of June 30, 2008, there was no unrecognized compensation cost related to unvested stock-based compensation arrangements granted under the Plan.

11. Warrants

In connection with the Convertible Note financing transaction that the Company entered into in July 2007, the Company issued warrants to purchase up to 997,702 shares of the Company s common stock at an exercise price of $1.24 per share. The closing price of the Company s common stock on the issue date of the warrants was $1.00 per share. The fair value of the warrants was approximately $601,000 and was determined using a Black Scholes pricing model using the following assumptions; volatility 67%, interest rate 4.8%, projected term seven (7) years, dividend yield zero. These warrants expire ten years from the date of issue and have a lock-up period of 12 months after any warrants are exercised. The Company recognized $601,000 of expense related to the issuance of the warrants as of March 31, 2008 upon repayment of the financing.

In connection with the Credit Facility that the Company entered into in January 2008, the Company issued Mr. Yager and Mr. Jones each 321,428 warrants to purchase the Company s common stock at a price per share equal to $.28 (the average closing price of our common stock on the American Stock Exchange for the five days immediately preceding the initial funding under the Credit Facility). The number of shares issuable for each warrant will be equal to (a) the principal amount of the Note issued at the initial closing multiplied by 0.30, divided by (b) the exercise price. The warrants have a term of five years. The company fully recognized warrant expense of $73,000 upon repayment of the Credit Facility in February 2008. The value was calculated using the Black Scholes pricing model with the following assumptions: volatility 67%, interest rate 4.8%, projected term five (5) years, dividend yield zero.

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12. Commitments

The Company was leasing its administrative and plant facilities and certain office equipment under noncancelable operating leases that expired in June 2008. The Company vacated those premises in June 2008 upon expiration of the lease. The Company entered into a new lease for an administrative and warehouse facility of approximately 1,200 square feet which will expire in December 2008 and has a monthly obligation of $1,200. Rent expense amounted to $153,000 and $145,000 for the three months ended June 30, 2008 and 2007, respectively. The Company is also responsible for common area maintenance costs, including taxes, insurance and other maintenance costs at its new facility.

Employee obligations consist of an employment agreement (the Employment Agreement ) with Thomas E. Jones, Chairman of the Board of Directors. The Employment Agreement does not have a specific term and provides for a base salary of $160,000 per year, which is subject to annual review by the Board of Directors. The Employment Agreement may be terminated at any time by the Company, with or without cause, and may be terminated by Mr. Jones upon 90 days notice. If Mr. Jones resigns or is terminated for cause (as defined in the Employment Agreement), he is entitled to receive only his base salary and accrued vacation through the effective date of his resignation or termination. If Mr. Jones is terminated without cause, he is entitled to receive a severance benefit in accordance with the Company s Severance and Change of Control Plan, or if not applicable, a severance benefit equal to 200% of his salary and incentive bonus for the prior fiscal year. In estimating its contractual obligation, the Company has assumed that Mr. Jones will voluntarily retire at the end of the year he turns 65 and that no severance benefit will be payable. This date may not represent the actual date the Company s payment obligations under the Employment Agreement are extinguished.

In addition to the severance agreement with Mr. Jones, the Company is also a party to a severance agreement with its CEO. Under the agreement, the CEO is entitled to a severance pay equal to 200% of his annual salary upon a change of duties, as defined in the agreement. The company has not recorded the obligation under the severance agreement for these two individuals because 100% of their salaries are still being accrued, and management believes a change in duties has not occurred. However, only a small fraction of their salary has been paid to them. Should the Company not pay their salary in full, or a change of duties occur, the Company will be obligated to pay them $800,000 in severance pay.

From time to time, the Company becomes involved in certain legal actions in the ordinary course of business. The Company is not currently a party to any pending legal actions.

13. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses, and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results may differ from those estimates.

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14. Accounting Standards

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option of Financial Assets and Financial Liabilities. SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected by reported in earnings. SFAS No. 159 is effective as of the beginning of the entity s first fiscal year that begins after November 15, 2007. SFAS No. 159 did not have any significant impact on the Company s financial statements.

In June 2006, the FASB issued interpretation no. 48, *Accounting for Uncertainty in Income Taxes- an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* (SFAS 109). This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. FIN 48 did not have any significant impact on the Company s financial statements.

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

Cautionary Statement

Certain statements in this report, including statements regarding our strategy, financial performance, and revenue sources, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, and are subject to the safe harbors created by those sections. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management s beliefs, and certain assumptions made by us. Such statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. The section entitled Risk Factors set forth in this Form 10-Q and similar discussions in filings with the Securities and Exchange Commission made from time to time, including other quarterly reports on Form 10-Q, our Annual Reports on Form 10-K, and in our other SEC filings, discuss some of the important risk factors that may affect our business, results of operations, and financial condition.

The following discussion should be read in conjunction with our condensed financial statements and notes thereto.

Overview

Chad Therapeutics, Inc., a California corporation (the Company ) was organized in August 1982 to develop, produce, and market respiratory care devices designed to improve the efficiency of oxygen delivery systems for both home and hospital treatment of patients who require supplemental oxygen (the oxygen business ). The Company introduced its first respiratory care device in the market in June of 1983 and introduced additional respiratory care devices in subsequent years. During the quarter ended March 31, 2008, the Company sold all of its assets related to the oxygen business.

The Company is currently focused exclusively on the development and commercialization of diagnostic and therapeutic devices for the multi-billion dollar sleep disorder market. Management believes that strong growth in the market for diagnostic and therapeutic devices for the sleep disorder market will continue to be driven by (1) increased understanding of the causes, symptoms and effects of sleep disorders, (2) growing clinical focus on the relationships between certain sleep disorders and certain serious diseases such as congestive heart disease, (3) increasingly frequent and accurate diagnosis of sleep disorders and (4) continued growth in the number of sleep diagnostic laboratories. In addition, on March 14, 2008, the Centers for Medicare Services ( CMS ) announced that, in addition to polysomnography performed in sleep laboratories, it will provide reimbursement for unattended home sleep testing with certain categories of devices. Management believes that this CMS ruling will lead to home testing of a substantial number of patients who would not otherwise have access to testing and,

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consequently, to a substantially larger market for treatment devices such as the Company s FloPAP device.

On November 16, 2007, the Company entered into a definitive agreement, subject to shareholder approval, to sell to Inovo, Inc. (the Buyer ) substantially all of the assets of the Company related to the oxygen conserver business including accounts receivable, inventory, and certain equipment and intellectual property (the Asset Sale ) pursuant to an Asset Purchase Agreement (the APA ). Pursuant to the APA, the Buyer assumed certain liabilities and obligations related to the Company s oxygen conserver business. The Company s shareholders voted to approve the sale of the Company s oxygen conserver business on January 31, 2008 and the Asset Sale was completed for $5,250,000 on February 15, 2008. On March 6, 2008, the Company entered into an Asset Purchase Agreement (the Purchase Agreement ) with Respironics, Inc., ( Respironics ). Pursuant to the Purchase Agreement, Respironics acquired the Company s assets related to the transfilling oxygen business, the Total O2 Delivery System, including the OMNI-5 In-Home Filling System, OMNI-2 In-Home Filling System, Omni Fill technology and the Company s Post Valve patent for the purchase price of $1,825,000. Under the terms of the Purchase Agreement, Respironics assumed certain liabilities and obligations related to the Company s transfilling oxygen business and the Company agreed to indemnify Respironics for expenses arising out of any breach of its representations or warranties. As a result of the discontinued operations presentation, the net earnings (loss) related to the discontinued operations of $(393,000) for the three-months ended June 30, 2007 has been presented in the Statements of Operations as a component of earnings (loss) from discontinued operations.

During the next twelve months, the Company intends to seek outside financing arrangements in order to facilitate its ability to fund anticipated capital expenditures, support its development of the sleep products, and enhance its working capital resources. Financing may be obtained through the sale of equity or debt securities, through the establishment of credit arrangements or through some combination of the foregoing. The Company has no established lines of credit or other arrangements in place to obtain working capital, and no assurance can be given regarding if and when other sources of working capital would be available. Moreover, the Company does not have in place any arrangements to raise additional funds through the sale of securities and it is not possible at this time to predict the terms upon which securities might be sold, or if the Company can raise any funds from prospective investors.

The operating results discussed below relate primarily to discontinued operations. Accordingly, the Company s future operating results will likely be materially different form the historical results discussed below.

Results of Operations

Due to the sale of the Company s oxygen assets, the Company does not have any sales for the three months ended June 30, 2008. In July 2008, the Company received 510k clearance from the FDA for its first sleep product.

Selling, general, and administrative expenditures for continuing operations decreased 38% as compared to the prior year due to the sale of the company s oxygen business.

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Research and development expense for continuing operations decreased by $16,000 as compared to the same period in the prior year. Currently management expects research and development expenditures to total approximately $950,000 in the fiscal year ending March 31, 2009, on projects to enhance and expand the Company s sleep product line. During fiscal year 2008, the Company spent $770,000 on research and development related to development of its sleep product line.

At March 31, 2008, the Company had Federal net operating loss carryforwards of $12,000,000 of which $1,459,000 expires in 2027 and the balance in 2028 and California net operating loss carryforwards of $11,255,000 of which $3,442,000 expires in 2013 and the balance expiring in 2014. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax asset will not be realized. At June 30, 2008 and 2007, the Company s deferred tax assets are fully offset by a valuation allowance. The Company will continue to assess the valuation allowance and to the extent it is determined that such allowance is no longer required, the tax benefit of the remaining net deferred tax assets may be recognized in the future.

Financial Condition

Liquidity

We do not have adequate capital resources to meet our obligations for the next 12 months. At June 30, 2008, the Company had cash totaling $683,000 or 39.8% of total assets, as compared to $2,068,000 (58.4% of total assets) at March 31, 2008. Net working capital decreased from $352,000 at March 31, 2008, to $(248,000) at June 30, 2008. Net accounts receivable decreased $423,000 during the three months ended June 30, 2008, due to the sale of the Company s oxygen product line. The Company sold all of its inventory due to the sale of its oxygen product line in the fourth quarter of fiscal year 2008.

Through June 30, 2008, the Company provided services under transition agreements with Inovo, Inc. and Respironics, Inc. Upon termination of those services, the Company has no further source of income until it is able to generate revenues from the sale of its products for the sleep disorder market. The Company received permission from the FDA to begin marketing the first of its sleep products in July 2008; however, no assurance can be given with respect to if and when the Company will begin to generate revenues from the sale of such products.

The Company s current operating plan contemplates monthly cash requirements of approximately $190,000 to pay for the development and commercialization of our products for the sleep disorder market.

In addition, we have outstanding certain severance obligations as a result of the termination of certain employees following the sale of our oxygen assets. As of June 30, 2008, the aggregate amount of such severance obligation is approximately $715,000 with $521,000 payable in September 2008, and $194,000 to be paid in December 2008.

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In order to have adequate funding to expedite the development and commercialization of our sleep disorder products and meet our outstanding obligations, we will require additional funding. Although several potential investors and strategic partners have expressed a preliminary interest in our sleep disorder products, we do not currently have in place any commitments for financing.

If we do raise additional financing through the sale of securities to support our sleep disorder strategy, the terms of any such financing may significantly dilute the equity interests of our current shareholders. Moreover, such financing may be in the form of senior equity with liquidation and other preferences over our common stock. The financing could also be in the form of convertible or non-convertible debt which could place significant restrictions upon our business operations.

If we are unable to raise sufficient funds to implement our strategy for the sleep disorder market, then our prospects for success will be materially diminished as we will lack the ability to aggressively market our sleep disorder products. Moreover, we will lack sufficient funds to meet all of our severance and other obligations as they mature.

Capital Resources

Historically, the Company had depended primarily upon its cash flow from operations to finance its operating expenses and to meet its capital requirements. However, recent operating trends have required the Company to seek outside financing in order to enhance its cash resources. The Company s cash flow for the three months ended June 30, 2008, was negative and the Company cannot predict if and when it will generate a positive cash flow from operations.

In March 2007, the Company entered into a one-year factoring arrangement that provided for the sale of up to $1,500,000 of the Company s accounts receivable. Assignments under the agreement incurred interest at the bank s prime rate plus two percent (2%) to three percent (3%) depending on the total accounts receivable balance. The Company had a minimum monthly interest payment of $6,000 beginning April 2007. The Company voluntarily terminated the factoring agreement on July 30, 2007 and paid all amounts due thereunder with proceeds from their financing arrangement with Calliope Capital discussed below.

On July 30, 2007, the Company entered into a financing transaction with Calliope Capital Corporation , a Delaware corporation (the Investor ) pursuant to which the Company issued to the Investor a $750,000 convertible term note ( Convertible Note ) and a $2,750,000 revolving credit line ( Credit Line ), all secured by the Company s assets. The Convertible Note was payable in equal installments over 36 months and bore interest at prime plus 2%, and the Credit Line bore interest at prime plus 1.5%. A portion of the financing was used to pay all outstanding obligations on the Company s factoring arrangement. The Company voluntarily terminated the Credit Line and Convertible Note on February 15, 2008 and paid all amounts due thereunder with proceeds from the sale of its oxygen conserver assets to Inovo.

In order to address the Company s limited ability to draw against its Credit Line at the end of the second fiscal quarter, on January 2, 2008, the Company entered a Subordinated

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Secured Note and Warrant Purchase Agreement (the Credit Facility ) with Mr. Earl Yager and Mr. Thomas Jones, our Chief Executive Officer and our Chairman of the Board, respectively. The Company entered into the financing arrangement after it was unsuccessful in obtaining financing on acceptable terms from a third party. The terms of the financing arrangement were negotiated and approved by the Company s independent directors who concluded that the terms were more favorable to the Company than those available from third party lenders. Pursuant to the terms of the Credit Facility, the Company could draw an aggregate of $1,000,000, subject to certain conditions. As of February 12, 2008, the Company had borrowed $550,000 under this facility. The Company voluntarily terminated the Credit Facility on February 15, 2008 and paid all amounts due thereunder with proceeds from the sale of its oxygen conserver assets to Inovo.

In connection with the Credit Facility, Mr. Yager and Mr. Jones each received 321,428 warrants to purchase our common stock at a price per share equal to $0.28 (the average closing price of our common stock on the American Stock Exchange for the five days immediately preceding the initial funding under the Credit Facility). The warrants have a term of five years.

Employee obligations consist of an employment agreement (the Employment Agreement ) with Thomas E. Jones, Chairman of the Board of Directors. The Employment Agreement does not have a specific term and provides for a base salary of $160,000 per year, which is subject to annual review of the Board of Directors. The Employment Agreement may be terminated at any time by the Company, with or without cause, and may be terminated by Mr. Jones upon 90-days notice. If Mr. Jones resigns or is terminated for cause (as defined in the Employment Agreement), he is entitled to receive only his base salary and accrued vacation through the effective date of his resignation or termination. If Mr. Jones is terminated without cause, he is entitled to receive a severance benefit in accordance with the Company s Severance and Change of Control Plan, or if not applicable, a severance benefit equal to 200% of his salary and incentive bonus for the prior fiscal year. In estimating its contractual obligation, the Company has assumed that Mr. Jones will voluntarily retire at the end of the year he turns 65 and that no severance benefit will be payable. This date may not represent the actual date the Company s payment obligations under the Employment Agreement are extinguished.

In addition to the severance agreement with Mr. Jones, the Company is also a party to a severance agreement with its CEO, Earl Yager. Under the agreement, the CEO is entitled to a severance pay equal to 200% of his annual salary upon a change of duties, as defined in the agreement. The Company has not recorded the obligation under the severance agreement for these two individuals because 100% of their salaries are still being accrued, and management believes a change in duties has not occurred. However, only a small fraction of their salary has been paid to them. Should the Company not pay their salary in full, or a change of duties occur, the Company will be obligated to pay them $800,000 in severance pay.

The Company has not adopted any programs that provide for post-employment retirement benefits; however, it has on occasion provided such benefits to individual

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employees. The Company does not enter into any transactions in derivatives, and has no material transactions with any related parties.

Off Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements with any special interest purpose entities or any other parties.

Critical Accounting Policies

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates under different assumptions and conditions. Management believes that the following discussion addresses the accounting policies and estimates that are most important in the portrayal of the Company s financial condition and results.

Allowance for doubtful accounts the Company provides a reserve against receivables for estimated losses that may result from our customers inability to pay. The amount of the reserve is based on an analysis of known uncollectible accounts, aged receivables, historical losses, and credit-worthiness. Amounts later determined and specifically identified to be uncollectible are charged or written off against this reserve. The likelihood of material losses is dependent on general economic conditions and numerous factors that affect individual accounts.

Inventories the Company provides a reserve against inventories for excess and slow moving items. The amount of the reserve is based on an analysis of the inventory turnover for individual items in inventory. The likelihood of material write-downs is dependent on customer demand and competitor product offerings.

Intangible and long-lived assets The Company s intangible assets consist of license fees and the costs associated with obtaining patents including legal and filing fees. At June 30, 2008, all of these intangible assets relate to products under development for the sleep disorder market. The Company uses actual costs when recording these intangible assets. If there is a triggering event, the Company assesses whether or not there has been an impairment of intangible and long-lived assets in evaluating the carrying value of these assets. Assets are considered impaired if the carrying value is not recoverable over the useful life of the asset. If an asset is considered impaired, the amount by which the carrying value exceeds the fair value of the asset is written off. In assessing the carrying amounts of the assets related to the sleep disorder market, the Company has considered the size of the market and potential future cash flows for these products based on statistics available through the National Institute of Health and Medicare, as well as data from other professional sources. The Company bases the useful life of its intangible assets on the assets patent life, currently 17 years. The Company utilizes patent life as its useful life due to its product history. The Company s experience has been that technology supported by the patents the Company has established is utilized for the entire life of the patent. The likelihood of a material change in the Company s reported results

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is dependent on each asset s ability to continue to generate income, loss of legal ownership or title to an asset, and the impact of significant negative industry or economic trends.

Deferred income taxes the Company provides a valuation allowance to reduce deferred tax assets to the amount expected to be realized. The likelihood of a material change in the expected realization of these assets depends on the Company s ability to generate future taxable income.

Revenue recognition The Company recognizes revenue when title and risk of loss transfers to the customer and the earnings process is complete. Under a sales-type lease agreement, revenue is recognized at the time of shipment with interest income recognized over the life of the lease. The Company records all shipping fees billed to customers as revenue, and related costs as cost of goods sold, when incurred.

Recently Issued Accounting Standards

Accounting standards promulgated by the Financial Accounting Standards Board change periodically. Changes in such standards may have an impact on the Company s future financial position.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option of Financial Assets and Financial Liabilities. SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected by reported in earnings. SFAS No. 159 is effective as of the beginning of the entity s first fiscal year that begins after November 15, 2007. SFAS No. 159 did not have any significant impact on the Company s financial statements.

In June 2006, the FASB issued interpretation no. 48, *Accounting for Uncertainty in Income Taxes- an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* (SFAS 109). This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. FIN 48 did not have any significant impact on the Company s financial statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risks

The Company has no significant exposure to market risk sensitive instruments or contracts.

Item 4. Controls and Procedures

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Item 4T. Controls and Procedures

**(a)** Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended). Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

(b) During the first quarter of 2008, there were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute assurance, that its objectives will be met. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

Part II

Other Information

Item 1. Legal Proceedings

None.

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

None.

Item 3. Defaults Upon Senior Securities

Not applicable.

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

None.

Item 5. Other Information

None.

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Item 6. Exhibits

10.24 1994 Stock Option Plan (1)

10.27 2004 Equity Incentive Plan (1)

10.28 Security Agreement dated July 30, 2007 (2)

10.29 Registration Rights Agreement dated July 30, 2007 (3)

10.30 Secured Convertible Term Note dated July 30, 2007 (3)

10.31 Secured Revolving Note dated July 30, 2007 (3)

10.32 Warrant dated July 30, 2007 (3)

10.33 Asset Purchase Agreement dated November 16, 2007(4)

31.1 Certification pursuant to Section 302 of Sarbanes-Oxley Act of 2002 for CEO

31.2 Certification pursuant to Section 302 of Sarbanes-Oxley Act of 2002 for CFO

32* Certification pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002

* The information in Exhibit 32 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act ) or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act

(including this quarterly report), unless CHAD Therapeutics specifically incorporates the foregoing information into those documents by reference.

(1) Previously filed as an exhibit to the Registrant s Annual Report on Form 10-K for the year ended March 31, 1996.

(2) Previously filed as an exhibit to the Registrant s Annual Report on Form 10-K for the year ended March 31, 1998.

(3) Previously filed as an Exhibit to the Registrant s Form 8-K dated August 3, 2007.

(4) Previously filed as an Exhibit to the Registrants Report on Form 10-Q for the quarter ended September 30, 2007.

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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.

| | |
|---|---|
| | CHAD THERAPEUTICS, Inc.<br>(Registrant) |
| Date 08/14/2008 | /s/ Earl L. Yager<br>Earl L. Yager<br>President and Chief Executive Officer |
| Date 08/14/2008 | /s/ Tracy A. Kern<br>Tracy A. Kern<br>Chief Financial Officer |

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INDEX TO EXHIBITS

| Exhibit No. | Description of Exhibits |
| --- | --- |
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