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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

Form 10-K

FOR ANNUAL AND TRANSITION REPORTS
PURSUANT TO SECTIONS 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended December 31, 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: 000-50789

Digirad Corporation

(Exact Name of Registrant as Specified in its Charter)

Delaware	**33-0145723**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
13950 Stowe Drive, Poway, CA	**92064**
(Address of Principal Executive Offices)	**(Zip Code)**

(858) 726-1600
(Registrant's Telephone Number, Including Area Code)

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

Title of Each Class	Name of Each Exchange on Which Registered
None	None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $0.0001 per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒.

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒.

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

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

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, based upon the closing stock price of the Common Stock reported on the NASDAQ National Market on June 30, 2006 was approximately $71.5 million. Shares of Common Stock held by each officer and director and by each person who owns 10% or more of the outstanding Common Stock of the registrant have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of outstanding shares of the registrant's common stock, par value $0.0001 per share, as of February 6, 2007 was 18,816,594.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement to be filed with the Securities and Exchange Commission within 120 days after registrant's fiscal year end December 31, 2006 are incorporated by reference into Part III of this report.

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DIGIRAD CORPORATION

FORM 10-K—ANNUAL REPORT
For the Fiscal Year Ended December 31, 2006

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PART I

Forward-Looking Statements

This report contains various forward-looking statements regarding our business, financial condition, results of operations and future plans and projects. Forward-looking statements discuss matters that are not historical facts and can be identified by the use of words such as "believes," "expects," "anticipates," "intends," "estimates," "projects," "can," "could," "may," "will," "would" or similar expressions. In this report, for example, we make forward-looking statements regarding, among other things, our expectations about the rate of revenue growth in specific business segments and the reasons for that growth and our profitability, uncertainties relating to our ability to compete, uncertainties relating to our ability to increase our market share, changes in coverage and reimbursement policies of third-party payors and the effect on our ability to sell our products and services, and our ability to timely develop new products or services that will be accepted by the market.

Although these forward-looking statements reflect the good faith judgment of our management, such statements can only be based upon facts and factors currently known to us. Forward-looking statements are inherently subject to risks and uncertainties, many of which are beyond our control. As a result, our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth below under the caption "Risk Factors." For these statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. You should not unduly rely on these forward-looking statements, which speak only as of the date on which they were made. They give our expectations regarding the future but are not guarantees. We undertake no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless required by law.

Corporate Information

Digirad Corporation was incorporated in Delaware in 1997. Unless the context requires otherwise, in this report the terms "we," "us" and "our" refer to Digirad Corporation® and our wholly-owned subsidiaries, Digirad Imaging Solutions®, Inc. and Digirad Imaging Systems, Inc. and their predecessors.

Item 1. Business

Overview

We are a leading provider of cardiovascular imaging services and solid-state nuclear medicine imaging products to physician offices, hospitals and imaging centers. We designed and commercialized the first solid-state nuclear gamma camera for the detection of cardiovascular disease and other medical conditions. Our imaging systems are mobile as well as fixed and provide enhanced operability, improved patient comfort and, in the case of our triple-headed Cardius®-3 XPO system, shorter image acquisition time, when compared to traditional vacuum tube cameras. The cameras and accompanying equipment fit easily into floor spaces as small as seven feet by eight feet and facilitate the delivery of nuclear medicine procedures in a physician's office, an outpatient hospital setting or within multiple departments of a hospital.

In addition to selling our imaging systems, we lease them through a comprehensive mobile imaging services program called FlexImaging® through our wholly-owned subsidiary, Digirad Imaging Solutions, Inc, or DIS. This mobile imaging service is an alternative to purchasing a gamma camera for physicians who wish to perform nuclear imaging procedures in their offices by leasing the imaging system, certified personnel and other support required to perform nuclear imaging in the physician office. The flexibility of our products and our DIS leasing service allows physicians more control over the diagnosis and treatment of their patients in their offices and to retain revenue from procedures that would otherwise be referred elsewhere. Our new Cardius®XPO camera series allows physicians to choose among single, dual or triple-head cameras to accommodate their practices' throughput needs, or to upgrade a single head camera to a dual or triple head configuration as their practice

grows or changes. As of December 31, 2006, we have integrated 19 triple-head cameras, most of which are Cardius-3 XPO mobile cameras into our DIS camera fleet to upgrade its speed, reliability, image quality and flexibility. In 2006, DIS performed more than 100,000 imaging procedures.

In fiscal 2006, we had consolidated revenues of $71.9 million and a net loss of $6.3 million. We had consolidated revenues of $68.2 million and a net loss of $9.6 million in fiscal 2005, and consolidated revenues of $68.1 million and net income of $0.2 million in fiscal 2004. Revenue from DIS and from our camera sales constituted 69.0% and 31.0%, respectively, of our 2006 consolidated revenues, 73.6% and 26.4%, respectively, of our 2005 consolidated revenues and 65.3% and 34.7%, respectively, of our 2004 consolidated revenues. We believe DIS will continue to comprise the largest component of our consolidated revenue. As of December 31, 2006, our total assets were $69.3 million, comprised of $55.1 million in the product business and $14.2 million in DIS.

Our 2006 operating results improved over those of 2005 for a number of reasons. During the year, we implemented operational and process changes that led to cost savings and productivity efficiencies. For example, in the product business, we outsourced certain manufacturing processes and reduced our workforce, and in DIS, we closed unprofitable hubs, reduced the costs of supplies and restructured our operational and management personnel to allow for more efficient local supervision. DIS reaped efficiency and cost benefits from our ongoing camera fleet upgrade and the elimination of certain pharmaceutical supplies. In the product business, the introduction of our line of Cardius XPO cameras allowed us to increase the proportion of multi-head cameras sold. We launched major software improvements that led to faster image acquisitions and improved clinical utility, and we sold more of our 2020tc or general purpose nuclear cameras to hospitals. Our growing installed base of cameras and their enhanced reliability and serviceability resulted in increased revenue and improved margins from camera maintenance and service agreements. We sold cameras to a number of large teaching universities and thought leaders, and saw the publication of research papers recognizing the benefits of upright imaging performed with our cameras.

We continue to face challenges from an overall declining market for nuclear imaging equipment, which has decreased by approximately 13% from $372 million in 2004 to $326 million in 2005, and another 10% during 2006, according to the National Electrical Manufacturers Association, or NEMA, despite U.S. procedure volume in nuclear medicine (excluding PET studies) growth of 15% between 2002 and 2005, according to IMV Medical Information. In 2006, we also experienced turnover in our executive management and sales organization, and an overall employee turnover of 65% in DIS and 41% in the product business. In DIS, we experienced an increase in lost business during the latter half of 2006 that was more than offset by an increase in the start of new business. We experienced downward pressures on the average sales price for all of our cameras. While reimbursement declines do not impact us directly because we do not bill Medicare or any third party payors, the market experienced declining Medicare reimbursement and requirements by some private payors for specific accreditation or credentialing of our services or ownership or full-time leasing of our imaging products, trends which we believe will continue. Our competitors introduced new nuclear gamma camera products, and competing modalities such as CT angiography, positron emission tomography and hybrid technologies may be affecting our market.

Despite these challenges, we were able to increase revenues and capture a larger share of the declining cardiac-specific nuclear equipment market, and continue to believe that our imaging systems' small size, mobility, and ability to accommodate physicians' varying throughput needs constitute significant competitive advantages. We also believe that the faster image acquisition speed of our Cardius XPO triple head camera will lead to shortened work days for our DIS employees with a corresponding decrease in employee turnover and improved customer satisfaction. In 2006, we strengthened our management team, re-aligned our sales organization and commenced various programs to reduce employee turnover. In addition, we continued the process of obtaining accreditation of our hubs by the Inter Societal Commission for the Accreditation of Nuclear Medicine, or ICANL, ending the year with 26 accredited hub locations. Before the end of the year, we signed our first contracts for the leasing of ultrasound services, and thus began what we anticipate will be a broadening of our service offerings.

Market Opportunity

Nuclear Imaging

Nuclear imaging is a form of diagnostic imaging in which depictions of the internal anatomy or physiology are generated primarily through non-invasive means. Diagnostic imaging facilitates the early diagnosis of diseases and disorders, often minimizing the scope, cost and amount of care required and reducing the need for more invasive procedures. Currently, five major types of non-invasive diagnostic imaging technologies are available: x-ray; magnetic resonance imaging; computerized tomography; ultrasound; and nuclear imaging. The most widely used imaging acquisition technology utilizing gamma cameras is single photon emission computed tomography, or SPECT. All of our current cardiac gamma cameras employ SPECT.

According to industry sources, despite the improved image quality and increasing utilization rates of competing modalities such as computed tomography, or CT, and magnetic resonance imaging, or MRI, and diagnostic procedures such as CT angiography, SPECT procedures performed with gamma cameras will continue to be used for a substantial number of cardiac specific nuclear imaging procedures. We believe continued utilization will be due to the lower purchase and maintenance costs, smaller physical footprint and easier service logistics of gamma cameras. In an emerging trend in cardiology, SPECT technologies are being integrated with other imaging modalities such as computed tomography, or CT, to form hybrid imaging modalities such as SPECT/CT. Hybrid imaging is believed to be advantageous because it combines the anatomical image benefits of CT with the functional information offered by SPECT into a single image, although hybrid systems remain substantially more expensive than gamma cameras.

Clinical Applications for Nuclear Imaging

Nuclear imaging is used primarily in cardiovascular, oncological and neurological applications. Nuclear imaging involves the introduction of very low-level radioactive material, called radiopharmaceuticals, into the patient's body. The radiopharmaceuticals are specially formulated to concentrate temporarily in the specific part of the body to be studied. The radiation signal emitted by the materials are then converted into an image of the body part or organ. Nuclear imaging, in contrast to other diagnostic imaging modalities, shows not only the anatomy or structure of an organ or body part, but also its function—including blood flow, organ function, metabolic activity and biochemical activity. Cardiologists and an increasing number of internists and other physicians purchase our cameras or services for in-office cardiac imaging. While we have concentrated our efforts on the nuclear cardiology market, sales of our 2020tc camera into the hospital for other nuclear applications, such as oncology, neurology and bone scans, have recently increased.

Our Services—Digirad Imaging Solutions (DIS)

DIS offers a comprehensive mobile imaging leasing service, called FlexImaging®, comprised of an imaging system, a certified nuclear medicine technologist and a certified cardiographic technician or registered nurse, the supply of radiopharmaceuticals, and required licensure for the performance of nuclear imaging procedures under the supervision of physicians. Our service infrastructure includes radioactive materials licensing policies and procedures, quality assurance, a staff of radiation safety officers, coordinated billing services, and a compliance plan to help ensure adherence to applicable state and federal regulations. A separate leasing program called DigiTech™ Professional Services allows physicians who have purchased a Digirad camera to lease all of the components of our FlexImaging program with the exception of the camera. DIS' customers are cardiologists, internists, a number of large, multi-practice groups and, on a more limited basis, hospitals and clinics. We provide our physicians with more control over their patients' diagnosis and treatment as well as incremental revenue opportunities from services they would otherwise refer to a hospital or imaging center. Physicians can tailor their nuclear imaging expenses to their practice needs and patient volumes.

Our DIS operations use a "hub and spoke" model in which centrally located regional hubs anchor multiple van routes in the surrounding metropolitan areas. As of December 31, 2006, we had a total of 211 employees in

our DIS business operating 38 hubs and sites and 83 cameras. At our DIS hubs, clinical personnel load the equipment, radiopharmaceuticals and other supplies onto specially equipped vans for transport to the physician's office, where they set up the equipment for the day. After quality assurance testing, and under the physician's supervision, a technologist will gather patient information, inject the patient with a radiopharmaceutical and then acquire the images for interpretation by the physician. The technologists furnish the physician with applicable paperwork and billing information for all patients and clean the utilized areas before departing.

We provide DIS leasing services under annual contracts for services delivered on a per-day basis. Under these agreements, physicians pay us a fixed amount for each day that they lease our equipment and personnel, and they commit to the scheduling of a minimum number of lease days during the lease term, which runs for at least one year. The same fixed payment amount is due for each day regardless of the number of patients seen or the reimbursement obtained by the physician.

Our Products

We sell a line of solid-state gamma cameras and accessories for general nuclear imaging and specific clinical-application imaging. In a typical nuclear cardiology procedure, the physician acquires two images from the patient, one while the patient's heart rate is at rest and the other after the heart has been stressed. The procedure begins with the injection of a small amount of radiopharmaceutical. A patient imaged by our gamma camera sits in an imaging chair and places both arms on a shoulder-level armrest. Image acquisition begins with the patient slowly rotating in front of the camera's detector head. The duration of the acquisition is a function of the patient's body mass, whether the test is performed with the heart at rest or under stress, the amount of radiopharmaceutical injected and the number of camera detectors on the system.

Stress images are acquired by stressing the heart, either through exercise or the use of other pharmaceuticals, and then injecting the radiopharmaceutical at the peak stress level. The difference between a resting and stress image allows the physician to determine the level of cardiac function. After collecting the images, the technologist performs the image reconstruction, checks the quality of the images and further processes the images. The physician then reviews the images and determines whether more invasive diagnostic procedures or therapeutic treatments are necessary.

Each of our imaging systems fits into a seven foot by eight foot room, and the systems generally do not require expensive room modifications or electrical changes. We currently offer the following products:

The *Cardius®3 XPO* imager is a stationary, triple-head gamma camera with an upright imaging chair designed for dedicated nuclear cardiology applications and high-procedure volumes. The Cardius-3 XPO imager features three Solidium® solid-state detector heads that provide high count imaging statistics, enhanced image quality and higher patient throughput. Because its image acquisition speed is 38% faster than that of a competing dual head camera, the system is well suited for high volume practices, large hospitals and busy outpatient imaging centers. This product is the only dedicated cardiac triple-head camera currently on the market. The Cardius-3M XPO is a mobile version of this triple-headed camera which we are currently integrating into our DIS camera fleet.

The *Cardius®2 XPO* imager is a stationary, dual-head gamma camera with an upright imaging chair designed for dedicated nuclear cardiology applications. The Cardius-2 XPO features two Solidium detector heads with excellent image quality and workflow efficiency. The Cardius-2 XPO imager is well-suited for mid-sized cardiology practices and hospitals and can be upgraded to a triple-headed camera.

The *Cardius®1 XPO* imager is a single-head gamma camera and patient chair designed for dedicated cardiology applications and lower procedure volumes; it can be configured as either a mobile or a stationary system. The Cardius-1 XPO also features our Solidium detector and can be upgraded to a dual or triple head camera as the user's imaging needs increase. We also sell a mobile version of the Cardius-1 XPO and use it in the DIS camera fleet.

The *2020tc*® imager is a mobile, single-head gamma camera that is compact and lightweight. The camera is used for general purpose imaging procedures taken from a single point of view, referred to as planar, ranging from bone scans to thyroid imaging. We sell this camera to hospitals as a secondary camera to increase their capacity and flexibility to image within multiple departments using a single asset.

The *SPECTpak PLUS*™ imager combines our 2020*tc* imager and SPECTour patient chair and provides both general purpose nuclear imaging and cardiology imaging, with the added flexibility of mobility. DIS has historically used the SPECTpak PLUS imager to provide mobile imaging services to its physician customers. We are in the midst of a three-year phase-out of the 2020tc from the DIS fleet in favor of our mobile Cardius-1 XPO or Cardius-3 XPO imagers or their predecessor versions, the Cardius-1-M and the Cardius-3-M.

Workstations, Connectivity and Accessories. We offer a line of high-performance workstations equipped with multiple software options for nuclear image interpretation. We also sell connectivity between imagers from the same or different manufacturers to physicians who wish to integrate studies from multiple imagers into one single workstation or archive. In addition, we offer a line of accessories, including hot lab equipment required for the use of radiopharmaceuticals, and various other supplies.

Competitive Strengths

We believe that our position as a market leader in the nuclear cardiac imaging market is a product of the following competitive strengths:

- *Leading Solid-State Technology.* Our solid-state gamma cameras utilize proprietary photo-detector modules which enable us to build smaller and lighter cameras that withstand vibration associated with transportation. We have continued to introduce faster and more versatile products, selling them to our customers and leasing them through our DIS service business.
- *Mobile Applications through Reduced Size and Weight*. Some of our cameras weigh less than 450 pounds and our imaging chairs weigh less than 350 pounds. The imager and chair of our largest, triple-head Cardius-3 XPO imager weigh a combined 775 pounds, and the accompanying acquisition and processing station weighs 350 pounds. Our dedicated cardiac imagers require a floor space of only seven feet by eight feet and generally can be employed without facility renovations. Our mobile cameras are ideal for physicians who wish to move them within a hospital or imaging facility, and for use in our DIS service business.
- *Speed and Image Quality.* We believe our Cardius-3 XPO camera has brought unparalleled image acquisition speed to the mobile environment. These high performance systems can acquire images 38% faster than a traditional dual head camera while maintaining the same image quality. Increased imaging speed optimizes workflow and resource utilization.
- *Enhanced Operability and Reliability.* We believe our imaging systems provide improved workflow, better power efficiency and increased reliability when compared to vacuum tube cameras. The modular design of our cameras also facilitates repairs and upgrades in the field, which are often accomplished by delivering replacement components overnight.
- *Improved Patient Comfort and Utilization.* We believe the upright and open architecture of our patient chair can reduce patient claustrophobia and increase patient comfort when compared to traditional vacuum tube-based imaging systems, the majority of which require the patient to lie flat and have detector heads rotate around the patient. Upright imaging positioning also reduces false indications that can result from organs pushing up against the heart while patients lie on their backs. Our Cardius XPO camera series can image patients weighing up to 500 pounds.
- *Unique Dual Sales and Service Offering.* We sell imaging systems to physicians who wish to perform nuclear imaging in their facilities and manage the related service logistics. Through DIS, we also lease our systems and certified personnel to physicians on an annual basis in flexible increments ranging

from one day per month to several days per week without requiring them to make a capital investment, hire personnel, obtain licensure and manage other logistics associated with operating a nuclear imaging site.

- *Intellectual Property Portfolio.* We have developed an intellectual property portfolio that includes product, component and process patents covering various aspects of our imaging systems. As of December 31, 2006, we owned 23 patents issued in the United States and 8 patents issued internationally. In addition to our patent portfolio, we have developed proprietary manufacturing and business know-how and trade secrets that we believe provide us with a competitive advantage.

Business Strategy

We intend to continue to expand our business, improve our market position and increase our revenues by pursuing the following business strategies:

- *Expand Our DIS Business.* We plan to expand our DIS business through increasing hub and system utilization by adding additional physician customers and routes to each hub location, expanding into new geographies and adding new hub locations in states in which we currently operate.
- *Drive Margin Improvements and Growth in the Product and the DIS Businesses.* We plan to enhance our margins in both the product and the services segments by improving our operating efficiencies, reducing manufacturing costs, reducing employee turnover, increasing the efficiency of our route operations and increasing product reliability.
- *Increase Market Share in Camera Sales.* Although the overall market for sales of cardiac-specific gamma cameras has declined, we believe that we can grow our share of this market by capitalizing on the continued trends of nuclear cardiac procedures shifting from the hospital to the physician office and from the cardiologist exclusively to internists and other physicians. We intend to expand our efforts in selling our general purpose nuclear camera in the hospital setting.
- *Diversify DIS Services by Offering Other Imaging Modalities.* In 2006, DIS signed its first contracts for the delivery of ultrasound imaging, and we intend to continue to expand DIS echocardiography and vascular ultrasound services and seek to add other imaging applications, modalities and solutions to physicians.
- *Continued Innovation in Solid-State Imaging Technology.* We intend to maintain our leadership position in solid-state imaging technology and software by continuing to invest resources in research and development. We believe we can continue to improve upon our existing technology to enhance image quality, improve user experience, maximize patient throughput, lower system cost and facilitate the ease of maintenance and repairs.

Sales and Marketing

In 2006, our sales and marketing organization was responsible for the marketing and sales functions of both our product and our services segments. During the year, we consolidated four national sales regions into three, and our Senior Vice President of Sales and Marketing led three Regional Vice Presidents and approximately thirty sales personnel, most of who sold both our products and our leasing services. By the end of the year, we reorganized the sales organization into two separate groups, one of which is now solely responsible for selling DIS services under the direction of the DIS President. We intend to hire additional sales personnel as we expand our business, and we will continue to employ sales specialists to assist with in-office or on-site camera demonstrations.

We also sell our imaging systems in Louisiana through a distributor, and we have a distributor in Russia whose distribution arrangement is exclusive. Although the revenues generated through these two distributors in 2006 were minor, we intend to establish additional distributor relationships in 2007. We select our distributors

based on their expertise in imaging systems and sales coverage, and we provide the distributors with the right to sell our products within their sales territory. In 2006, we also established a sales and marketing arrangement with a nuclear and ultrasound service provider in Georgia to deliver DIS services in Atlanta and the surrounding region.

Maintenance and Product Service

We ended 2006 with an installed base of 83 cameras. This increased base and the implementation of programs to reduce our costs, improve the reliability of our cameras and increase the efficiency of our repair and service functions resulted in increased revenues and better margins from our product maintenance and service contracts. We often service our domestic customer's remotely through high-speed Internet access and dial-up connections that facilitate system diagnosis without the need for field service or repair. When repair is required, our modular part replacement capability allows our field service engineers to perform field repairs that minimize customer downtime. We also employ applications specialists to train our customers or provide technical support on the use of our products.

Manufacturing

We have been manufacturing our cameras since March 2000. The key components of our cameras' mechanical and electrical systems are designed or configured by us. Our manufacturing strategy combines our internal design expertise and proprietary process technology with strategic outsourcing. In 2006, we achieved cost efficiencies by outsourcing additional manufacturing processes to companies that meet the standards of the FDA and the International Organization for Standardization, or ISO. We expect to continue outsourcing additional components and processes to gain efficiencies and costs savings. We perform subassembly and final system performance tests, packaging and labeling at our facility. We provide connectivity solutions which include consulting, configured computers and outsourced electronic image management systems. We also sell accessories which are outsourced and include printers, equipment for handling and measuring radioactive materials and software for the camera.

Suppliers of critical materials, components and subassemblies undergo ongoing quality certification by us. Most components used in the product are available from multiple sources; however, we do not currently maintain alternative manufacturing sources for the imaging processing software and for a number of other materials or components. We are currently qualifying or seeking secondary sources. We use enterprise resource planning and collaborative software to increase efficiency and security in handling of material and inventory, centralizing our purchasing procedures, monitoring our inventory supplies and streamlining our billing methods.

We and our third-party manufacturers are subject to the FDA's Quality System Regulation, state regulations such as the regulations promulgated by the California Department of Health Services, and regulations promulgated by the European Union. We are currently certified under the ISO 13485:2003 quality standard.

Research and Development

As of December 31, 2006, our research and development staff consisted of 17 employees. We have a long and extensive commitment to research and development, including an established history in developing innovative solid-state gamma cameras. Some of the critical research and development milestones we have achieved include our launch of the first solid-state gamma camera for medical use in 2000; the release of the first dual-head, solid state camera in 2002; the launch of our third-generation Solidium detector, which improved the reliability and sensitivity of our gamma cameras, in 2003; the release of the first dedicated triple-head cardiac camera, the Cardius-3, in 2004; and the release of our advanced Cardius XPO series of cameras, including our mobile triple-headed Cardius-3M XPO, in 2006.

We have an established core competency in the development of silicon photodiodes and related scintillator assemblies and signaling processing electronics, which are the core of our gamma cameras. In addition, we are building a world class image reconstruction team.

Our research and development efforts are primarily focused in the near term on developing further enhancements to our existing products as well as developing our next-generation products. Our objective is to increase the image quality, sensitivity and reliability of our imaging systems and their clinical and economic benefit to our physician customers and their patients. Our research and development expense was $3.9 million, $3.7 million and $3.1 million in 2006, 2005 and 2004, respectively.

Competition

The medical device industry, including the market for nuclear imaging systems and services, is highly competitive, subject to rapid change and affected by new product and service introductions and market activities of other industry participants. In selling and leasing our imaging systems, we compete against several large medical device manufacturers, including Philips Medical Systems, General Electric Healthcare, Siemens Medical Systems and Toshiba Medical Systems, most of whom offer a full line of imaging cameras for each diagnostic imaging technology, including x-ray, MRI, CT, ultrasound and nuclear medicine, or SPECT/CT and PET/CT hybrid imaging. The existing nuclear imaging systems sold by these competitors have been in use for a longer period of time than our products and are more widely recognized and used by physicians and hospitals for nuclear imaging. Many of our competitors and potential competitors enjoy significant competitive advantages over us, including:

- significantly greater name recognition and financial, technical and marketing resources;
- established relationships with healthcare professionals, customers and third-party payors;
- established distribution networks;
- additional lines of products and the ability to offer rebates or bundle products to offer discounts or incentives;
- robust software and connectivity capabilities; and
- greater resources for product development, sales and marketing.

We are aware of certain major medical device companies that are developing solid-state gamma cameras that may compete with our product offerings. In addition, we are aware of a privately-held company, Gamma Medica, that is currently marketing a solid-state gamma camera for pre-clinical animal imaging and breast imaging. While we do not believe this camera is currently aligned to be used in a cardiac application, we cannot assure you that Gamma Medica will not attempt to modify its existing camera for use in the cardiac segment in the future, or develop another gamma camera for cardiac applications. We are also aware of a second company, Spectrum Dynamics, that has demonstrated a proof-of-concept solid-state gamma camera that we believe it may market in the cardiac segment, and a third company, Spectrica, that has developed a mobile cardiac camera based on vacuum tube technology.

In providing DIS lease services, we compete against businesses employing traditional vacuum tube cameras that must be transported in large vehicles and cannot be moved in and out of physician offices. We also compete against a number of physicians and local, regional and national companies that use Digirad cameras or place low-cost refurbished cameras into physician offices and then provide the staffing, supplies and other support as an alternative to a DIS lease. In addition, we compete against imaging centers that install nuclear gamma cameras and make them available to referring physicians in their geographic vicinity.

We believe that the principal competitive factors in our market include:

- improved outcomes for nuclear imaging procedures;
- acceptance by physicians;
- ease of use, reliability and mobility;

- product price;
- qualification for reimbursement;
- technical leadership and superiority;
- effective marketing and distribution; and
- speed to market.

Intellectual Property

We rely on a combination of patent, trademark, copyright, trade secret and other intellectual property laws, nondisclosure agreements and other measures to protect our intellectual property. We require our employees, consultants and advisors to execute confidentiality agreements and to agree to disclose and assign to us all inventions conceived during the work day, using our property, or which relate to our business. Despite any measures taken to protect our intellectual property, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary.

Patents

We have developed a patent portfolio that covers our overall products, components and processes. As of December 31, 2006, we had 23 issued U.S. patents, 8 foreign patents and 35 pending patent applications, including 17 U.S. applications, 4 international Patent Cooperation Treaty, or PCT, applications and 14 foreign applications seeking protection for selected patents in Japan, Canada and Russia. The issued and pending patents cover, among other things, aspects of solid-state radiation detectors including our photodiodes, signal processing, and system configuration. Our issued patents expire between December 23, 2014 and April 20, 2021. We have multiple patents covering unique aspects and improvements for many of our products. We have entered into a royalty-bearing license for one U.S. patent with a third party for exclusive use in nuclear imaging (subject to certain reservation of rights by the U.S. Government). In addition to our solid-state detector and photodiode technology patents, we hold specific patents for an alternative solid-state method using Cadmium Zinc Telluride that we previously pursued for use in gamma cameras. While each of our patents applies to nuclear medicine, many also apply to the construction of area detectors for other types of medical imagers and imaging methods.

Trademarks

As of December 31, 2006, we hold trademark registrations in the United States for the following marks: 2020tc Imager®, CardiusSST®, Digirad®, Digirad Logo®, Digirad Imaging Solutions®, FlexImaging® Cardius®, SPECTour®, and Solidium®. We have trademark applications pending in the United States for the following marks: DigiServ™, DigiTech™, Solidium™, SeeQuanta™, AcqSmart™, SPECTpak Plus™, Stasys™, Cardius X-Act™, and TruAcq CountBased Imaging™. We have obtained and sought trademark protection for some of these listed marks in the European Community and Japan.

Government Regulation

We must comply with a mosaic of federal and state laws and regulations. Violations of such laws and regulations can be punishable by criminal, civil and/or administrative sanctions, including, in some instances, imprisonment and exclusion from participation in federal and state healthcare programs, such as Medicare and Medicaid. Federal and state governmental agencies are continuing heightened enforcement efforts in the healthcare industry, and whistleblower cases are becoming more common. Accordingly, we maintain a compliance program and hotline that permits our personnel to report violations anonymously. Our compliance committee, consisting of senior management and legal counsel, meets regularly to provide oversight of our compliance initiatives. We also conduct periodic audits to help ensure compliance with applicable laws.

The following is a summary of some of the laws and regulations governing our business:

(1) *Anti-Kickback Laws.* The Medicare/Medicaid Anti-Kickback Statute prohibits us from knowingly and willingly offering, paying, soliciting or receiving any form of remuneration in return for the referral of items or services, or to purchase, lease, order or arrange for or recommend purchasing, leasing or ordering any good, facility service or item, for which payment may be made under a federal healthcare program. Violation of the federal anti-kickback law is a felony, punishable by criminal fines and imprisonment for up to five years or both, and can result in civil penalties and exclusion from participation in federal healthcare programs such as Medicare and Medicaid. Many states have adopted similar statutes prohibiting payments intended to induce referrals of products or services paid by Medicaid or other nongovernmental third party payors.

2) *Physician Self-Referral Laws.* Federal regulations commonly referred to as the "Stark Laws" prohibit physician referrals of Medicare or Medicaid patients to an entity for certain designated health services if the physician or an immediate family member has an indirect or direct financial relationship with the entity, and no exception applies. We believe that our physician customers generally should be eligible to qualify for the "in-office ancillary services" exception to the Stark Laws, provided they meet the definition of a "group practice" under the Stark law, personally supervise individuals performing the nuclear imaging services and bill for them, and the services are performed in the same building in which the physicians regularly practice medicine. Violations of the Stark Laws may lead to the imposition of penalties and fines, the exclusion from participation in federal healthcare programs, and liability under the federal False Claims Act and its whistleblower provisions. Many states have adopted similar statutes prohibiting self-referral arrangements covering all patients that are not limited to Medicare and Medicaid patients.

(3) *Pharmaceutical Regulation.* Federal and state agencies, including the FDA and state pharmacy boards, regulate the radiopharmaceuticals and pharmacological stress agents used in our DIS business. These agencies administer laws governing the manufacturing, sale, distribution, use, administration, prescribing and dispensing of drugs. Some of our activities may be deemed by relevant agencies to require permits or licensure under these laws that we currently do not possess.

(4) *Radioactive Materials Laws.* We must maintain licensure under, and comply with, federal and state radioactive materials laws, or RAM laws. RAM laws require, among other things, that radioactive materials are used by, or that their use be supervised by, individuals with specified training, expertise and credentials and include specific provisions applicable to the medical use of radioactive materials. In our case, the authorized user must be a physician with training and expertise in the use of radioactive materials for diagnostic purposes. We have entered into contracts with qualified physicians in each of our regions to serve as authorized users. Because our physician customers in our lease services business are not licensees and in most cases are not qualified to serve as authorized users, they perform nuclear medicine procedures as "supervised persons."

(5) *Federal False Claims Act.* The federal False Claims Act imposes civil and criminal liability on individuals or entities for the submission of false or fraudulent claims for payment to the government. Violations of the federal False Claims Act may result in civil penalties and exclusion from participation in federal healthcare programs. The federal False Claims Act also allows a private individual to bring a qui tam suit on behalf of the government against an individual or entity for violations of the False Claims Act. In a qui tam suit, a private plaintiff initiates a lawsuit for money of which the government was defrauded. If successful, the private plaintiff is entitled to receive up to 30% of the recovered amount plus reasonable expenses and attorney's fees. A number of states have enacted laws modeled after the False Claims Act.

(6) *HIPAA*. The Health Insurance Portability and Accountability Act of 1996 ("HIPAA") prohibits schemes to defraud healthcare benefit programs and fraudulent conduct in connection with the delivery of or payment for healthcare benefits, items or services. HIPAA also establishes standards governing electronic healthcare transactions and protecting the security and privacy of individually identifiable health information. Some states have also enacted privacy and security statutes or regulations that, in some cases, are more stringent than those issued under HIPAA.

(7) *Medical Device Regulation.* The FDA classifies medical devices such as our cameras into one of three classes, depending on the degree of risk associated with the device and the extent of control needed to ensure safety and effectiveness. Devices deemed to pose lower risk are placed in either class I or II, which generally requires the manufacturer to submit to the FDA a pre-market notification requesting permission for commercial distribution. This process is known as 510(k) clearance. Our cameras are Class II medical devices which have been cleared for marketing by the FDA. After a device receives 510(k) clearance, any modification that could significantly affect its safety or effectiveness or that would constitute a major change in its intended use requires a new 510(k) clearance. The FDA requires each device manufacturer to determine itself whether a modification requires a new clearance or approval, but the FDA can disagree with a manufacturer's determination. If so, the FDA can require the manufacturer to cease marketing and/or recall the modified device until 510(k) clearance or approval is obtained. To date, we have not been required to, and have not, submitted a PMA with respect to any of our products. We are also subject to post-market regulatory requirements relating to our manufacturing process, sales and marketing activities, product performance and medical device reports related to deaths and serious injuries associated with our products.

Reimbursement

Our customers typically rely on the Medicare and Medicaid programs and private payors for reimbursement. As a result, demand for our products is dependent in part on the coverage and reimbursement policies of these payors. Third party coverage and reimbursement is subject to extensive federal, state, local and foreign regulation, and private payor rules and policies. In many instances, the applicable regulations, policies and rules have not been definitively interpreted by the regulatory authorities or the courts, and are open to a variety of interpretations and are subject to change without notice.

The scope of coverage and payment policies vary among third-party private payors. For example, some payors will not reimburse a provider unless the provider has a contract with the payor, and in many instances such payors will not enter into such contracts. Other payors prohibit reimbursement unless physicians own or lease our cameras on a full-time basis, or meet certain accreditation or privileging standards. Such payor requirements and limitations can significantly restrict the types of business models we can successfully utilize.

We believe we have structured our contracts in a manner that allows our customers to seek reimbursement from third party payors in compliance with law. Our physician customers typically bill globally for both the technical and professional components of the tests. Assuming they meet certain requirements, including but not limited to performing and documenting bona fide interpretations and providing the requisite supervision of the non-physician personnel performing the tests, they may bill and be paid by Medicare. However, if they fail to comply with the terms of their contracts with us or are deemed not to meet payor requirements, all or a portion of their requests for reimbursement could be denied. If the failure to comply is deemed to be "knowing" or "willful", the government could seek to impose fines or penalties, and we may be required to restructure our agreements with them and/or respond to any resultant claims by such customers or the government. Our hospital customers typically seek reimbursement by Medicare for outpatient services under the Medicare Outpatient Prospective Payment System.

Employees

As of December 31, 2006, we had a total of 371 employees, of which 175 were employed in clinical and regulatory, 84 in operations, 61 in general and administrative 34 in sales and marketing and 17 in research and development. We had a total of 211 employees in our DIS subsidiary. None of our employees are represented by a labor union. We have not experienced any work stoppages and consider our employee relations to be good.

Available Information

We file electronically with the Securities and Exchange Commission, or SEC, our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K pursuant to Section 13(a) or 15(d) of the

Securities Exchange Act of 1934. The public may read or copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The address of that site is *http://www.sec.gov.*

You may obtain a free copy of our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K and amendments to those reports on the day of filing with the SEC on our website on the World Wide Web at *http://www.digirad.com*, by contacting the Investor Relations Department at our corporate offices by calling 858-726-1600 or by sending an e-mail message to our investor relations consultants at dgilette@berkmanassociates.com.

ITEM 1A. RISK FACTORS

Risks Related to Our Business and Industry

Our industry is highly competitive, and we compete against large, well-established competitors that have significantly greater financial resources than we have.

The nuclear imaging industry is highly competitive, subject to rapid change and significantly affected by new product introductions and market activities of other industry participants. Our primary competitors with respect to nuclear imaging systems include Philips Medical Systems, General Electric Healthcare, Siemens Medical Systems and Toshiba Medical Systems. All of these competitors offer a full line of imaging cameras for each diagnostic imaging technology, including x-ray, magnetic resonance imaging, computerized tomography, ultrasound and nuclear medicine, as well as hybrid modalities that combine, for example, the technologies of positron emission tomography, or PET, with computed tomography, or CT. Many of our competitors and potential competitors enjoy significant advantages over us, including:

- significantly greater name recognition and financial, technical, service and marketing resources;
- established relationships with healthcare professionals, customers and third-party payors;
- established distribution networks;
- technical features our current products do not possess;
- multiple product lines and the ability to offer rebates or bundle products to offer discounts or incentives; and
- greater resources for product development, sales and marketing.

Certain major medical device companies are developing solid-state cameras that may compete with our product offerings. A privately-held company, Gamma Medica, is marketing a solid-state gamma camera for breast imaging. A second company, Spectrum Dynamics, has demonstrated a proof-of-concept solid-state gamma camera that we believe it may market in the cardiac segment, and a third company, Spectrica, has developed a mobile cardiac camera based on vacuum tube technology. We anticipate that additional companies will dedicate significant resources to developing competing products and services, that may demonstrate better image quality, ease of use or mobility than our imaging systems. If we are unable to compete effectively against our existing and future competitors, our sales will decline and our business will be harmed.

The competitive nature of the nuclear imaging industry has had an impact on the volume of sales and pricing of our gamma cameras. We anticipate that pricing pressures will continue to affect our gamma camera product revenue and gross profit.

In providing DIS lease services, we compete against small businesses employing traditional vacuum tube cameras that cannot be moved in and out of physician offices. We also compete against physicians and companies that use Digirad cameras in local, regional and national mobile imaging businesses, some of which

have the advantage of a lower cost structure. In addition, we compete against imaging centers that install nuclear gamma cameras and make them available to referring physicians in their geographic vicinity. If these competitors are able to win significant portions of our business, our sales will decline and our business will be harmed.

If the market for nuclear imaging cameras continues to decrease, or if we are not successful in expanding our market share or product and service offerings, our revenues will decline and our business will be harmed.

The National Electrical Manufacturers Association, or NEMA, estimates that sales of nuclear imaging equipment, excluding maintenance revenue, declined approximately 10% in 2006. We believe this decline may be attributable to concerns about reimbursement changes and the increasing adoption of alternative imaging modalities, such as magnetic resonance imaging, computerized tomography, positron emission tomography, and hybrids among these modalities. We believe our market has been negatively affected by declining reimbursement, significant pricing pressures in the product business, and continuing efforts by some third party payors to reduce health care expenditures by requiring physicians to obtain specific accreditations or certifications, or restricting the use of mobile or leased cameras. A number of smaller companies have recently begun to market mobile nuclear imaging cameras for cardiac applications, and we believe competition from local or regional companies providing mobile imaging services has increased. We expect each of these trends to continue.

If these trends continue and we are unable to offset their effects on our business by expanding our market share or successfully introducing alternative products and services, our business will be significantly harmed.

Changes in coverage and reimbursement policies of third-party payors may adversely impact our ability to market and sell our products and services.

Private third-party payors continue to act to contain or reduce healthcare costs through various means, including the movement to managed care systems where healthcare providers contract to provide comprehensive healthcare for a fixed fee per patient. A number of third party payors in geographic locations currently served by us issued guidelines prohibiting our physician customers from obtaining reimbursement for procedures they perform unless they own or lease our cameras on a full time basis. These and other payors are also requiring physicians to be accredited by either the Intersocietal Commission for the Accreditation of Nuclear Medicine Laboratories (ICANL) or by the American College of Radiology, and to meet certain other privileging standards. Some of these privileging standards also exclude physicians who are not radiologists or cardiologists from obtaining reimbursements for nuclear imaging procedures. We cannot assure you that these guidelines will be changed, or that they will not be adopted by other third party payors, including Medicaid and Medicare. These continued efforts to restrict reimbursement have resulted in the denial of reimbursement in some instances. An increase in such denials will negatively affect our DIS business and product sales.

Failure to attract qualified managers, engineers and imaging technologists, or high employee attrition rates, could limit our growth and adversely affect our business.

Our success is dependent on the efforts of our key executives and technical, sales and managerial personnel and our ability to retain them. Losing any one or more of these individuals could place a significant strain on our remaining management team and we may have difficulty replacing any of these individuals. Furthermore, our future growth and ability to generate profits will depend in part upon our ability to identify, hire and retain nuclear imaging technologists, certified cardiographic technicians, nurses, radiation safety officers, engineers, management, sales personnel and other highly skilled personnel.

Hiring qualified management and technical personnel will be difficult due to the limited number of qualified candidates. Competition for these types of employees, particularly nuclear imaging technologists and engineers, is intense in the medical imaging field. Failure to attract, hire and retain key personnel could have an adverse

effect on our business, financial condition and results of operations. For the year ended December 31, 2006, we experienced a 54.4% rate of employee turnover for the combined service and product segments. If we are unable to improve upon this metric, our business and financial condition may continue to be adversely affected.

Our imaging systems and DIS services may become obsolete, and we may not be able to timely develop new products, product enhancements or services that will be accepted by the market.

Our nuclear imaging systems and DIS services may become obsolete or unmarketable if other products or services utilizing new technologies or the development of hybrid imaging modalities are introduced by our competitors or new industry standards emerge. For example, although we have begun to upgrade our existing single-head DIS mobile camera fleet with our mobile triple-head cameras to avoid obsolescence, we cannot assure you that our triple head cameras will not become obsolete. Nor can we assure you that any future products and enhancements will be accepted by the market. To be successful, we will need to enhance our products or services and to design, develop and market new products that successfully respond to competitive developments, all of which efforts may be expensive and time consuming.

The success of any new product offering or enhancement to an existing product will depend on several factors, including our ability to:

- properly identify and anticipate physician and patient needs;
- develop new products or enhancements in a timely manner;
- obtain the necessary regulatory approvals or clearances for new products or product enhancements in a timely manner;
- provide adequate training to users of our products;
- price our products competitively;
- obtain required licensure;
- continue to offer cost-competitive products and services despite increasing reimbursement restrictions and pricing pressures;
- comply with changing or new regulatory requirements; and
- develop an effective marketing, sales and distribution network.

If we are unable to meet these requirements, our business, financial condition and results of operations will likely suffer. In addition, even if our customers acquire new products, services or product enhancements, the revenues from such sales may not be sufficient to offset the significant costs associated with developing and offering such products, services or enhancements to customers. In addition, any announcements of new products, services or enhancements may cause customers to decline or cancel their purchasing decisions in anticipation of replacements.

If we are unable to expand our DIS business, our growth rates could be significantly diminished and our business could be materially harmed.

We plan to grow our DIS business by expanding into new states, adding new hub locations in states in which we currently operate and increasing existing hub utilization by adding physician customers and routes. Our progress in expanding into new geographies has been slower than anticipated, our hub utilization and customer density have decreased, and we cannot assure you that we will be able to sell our leasing services at the rates we anticipate, or that physicians or hospitals in these new markets will accept our imaging products or services. Our expansion into additional markets is subject to inherent risks, including those associated with compliance with applicable state laws and regulations. We may find the laws of states in which we do not currently operate preclude us from operating our DIS business, or require us to change the structure in which we operate our DIS business in such states. Our inability to expand into new markets for any of these reasons could diminish our prospects for growth and profitability.

Because our imaging systems and DIS services are not widely diversified, a decrease in sales of our products and leasing services could seriously harm our business.

Our current product and service offerings consist primarily of our line of gamma cameras, including our Cardius-1 XPO Series, Cardius-2, Cardius-3, 2020*tc* Imager and SPECTpak PLUS camera systems, each of which is designed for use in the nuclear imaging market segment and all of which utilize the same solid-state technology. In addition, our DIS mobile imaging leasing service utilizes our own line of cameras and at present is focused nearly exclusively on nuclear cardiology. As such, our line of products and services is not as diversified as those of some of our competitors. If the sales of our products or leasing services decline, our business would be seriously harmed, and it would likely be difficult for us to recover because we do not have the breadth of products or services that would enable us to sustain our business while seeking to develop new types of products or services or other markets for our existing products and services. In addition, because our technical know-how and intellectual property have limited applications, we may be unable to leverage these assets to diversify our products and services or to develop other products or sources of revenue outside of the nuclear imaging market.

If we experience problems with the technologies used in our imaging systems or if delivery of our DIS services is delayed, public perception of our products and service offerings could be harmed and we may lose customers and revenue.

In the past we have experienced some reliability issues with our camera detector heads and other parts of our imaging systems, and some of the cameras in our DIS fleet are more than four years old. Although we have embarked on a program to upgrade our fleet over the next three years, as the period of use of our cameras increases, other significant defects may occur. Equipment failures could result from any number of causes, including equipment aging, ordinary wear and tear due to regular transportation and relocation, failure to perform routine maintenance and latent hardware or software defects of which we are unaware. If significant defects do arise with our gamma cameras, our reputation among physicians and hospitals could be damaged and our business would be harmed.

Additionally, physicians rely on our DIS services to provide nuclear imaging procedures to their patients on the dates and at the times they have leased. Many factors could prevent us from delivering our DIS services on a timely basis, including equipment failures, unanticipated problems with our new mobile Cardius-3XPO camera, weather and the availability of staffing, transportation and necessary supplies. If we are unable to provide physicians or hospitals our DIS services in a timely and effective manner, our reputation among physicians and hospitals could be damaged and our business would be harmed.

We are subject to the financial risks associated with providing services through our DIS business.

There are numerous risks associated with any leasing arrangement, including the possibility that physicians may fail to make the required payments under the terms and provisions of their lease commitments. Our DIS business is also affected by the ability of physicians to pay us, which in turn may be affected by general economic and business conditions and the availability of reimbursement for the physicians. In addition, typically, a number of our DIS customers decide to purchase their own cameras, made by us or by one of our competitors, rather than continue to use our DIS leasing service. If purchases by DIS customers of cameras made by our competitors were to increase, our business and financial condition could be adversely affected. In addition, the number of customers who have canceled or failed to renew their lease contracts recently has increased, and our business may be significantly harmed if this trend continues.

Our manufacturing operations are highly dependent upon third-party suppliers, making us vulnerable to supply problems and price fluctuations, which could harm our business.

We rely on a limited number of third parties to manufacture and supply certain of the key components of our products. While many of the components used in our products are available from multiple sources, we obtain some components from single sources, and alternative sources for them may not be readily available. For

example, key components of the detector heads and the processing and control software utilized in our gamma cameras are manufactured or supplied by a single source. If we were unable to obtain these components, our ability to build gamma cameras could be materially affected, and we could experience delays in the production of our gamma cameras for an extended period of time that could cause the loss of customers and revenue.

Our reliance on these outside suppliers subjects us to a number of risks that could harm our business, including:

- suppliers may make errors in manufacturing components that could adversely affect the efficacy or safety of our products or cause delays in shipment of our products;
- we may not be able to obtain adequate supply in a timely manner or on commercially reasonable terms;
- we may have difficulty locating and qualifying alternative suppliers for our components;
- once we identify alternative suppliers, we could experience significant delays in production due to the need to evaluate and test the products delivered by alternative suppliers and to obtain regulatory qualification for them;
- we are not a major customer of many of our suppliers, and these suppliers may therefore give other customers' needs higher priority than ours;
- we use some suppliers that are small, privately-held companies, and these suppliers could encounter financial or other difficulties that could cause them to modify or discontinue their operations at any time;
- our suppliers manufacture products for a range of customers, and fluctuations in demand for the products those suppliers manufacture for others may affect their ability to deliver components to us in a timely manner; and
- our suppliers may encounter financial hardships unrelated to our demand for components, which could inhibit their ability to fulfill our orders and meet our requirements.

We have limited marketing, sales and distribution capabilities.

Our future revenue growth will depend in large part on our success in maintaining and expanding our marketing, sales and distribution channels, which is an expensive and time-consuming process. We are highly dependent upon the efforts of our sales force and third-party distributors to increase our revenue. We use one independent distributor in the United States and an independent, international sales distributor to market, sell and distribute our products and services. Our domestic third-party distributor is generally permitted to market, sell and distribute competing imaging products that are used or refurbished and meet specified age requirements. Our international distributor is prohibited from promoting or distributing any other gamma camera product, but not prohibited from offering competing services. We face intense competition for qualified sales employees and may be unable to hire, train, manage and retain such personnel, which could adversely affect our ability to maintain and expand our marketing, sales and distribution network. If we are unable to maintain and expand our direct and third-party marketing, sales and distribution networks, we may be unable to sell enough of our products and imaging services for our business to be profitable and our financial condition and results of operations will likely suffer.

We are exposed to risks relating to product liability, product recalls, property damage and personal injury and death for which insurance coverage is expensive, limited and potentially inadequate, and our business may be negatively affected by insufficiently insured claims and increased insurance costs.

Our operations entail risks relating to claims or litigation relating to product liability, warranty, product recalls, property damage, misdiagnosis, personal injury and death. We may incur significant liability in the event of any such litigation, regardless of the merit of the action. We currently maintain insurance that we believe is adequate with respect to the nature of the risks insured against, including product liability insurance, professional

liability insurance, automobile insurance, property insurance, workers compensation insurance and general liability insurance. In many cases such insurance is expensive and difficult to obtain, and no assurance can be given that we will be able to maintain our current insurance or that we will be able to obtain or maintain comparable or additional insurance in the future on reasonable terms, if at all. If we are unable to obtain insurance, or if our insurance is inadequate to cover claims, our cash reserves and other assets could be jeopardized. Additionally, costs associated with maintaining our insurance could become prohibitively expensive, and our ability to become profitable could be diminished.

If we choose to acquire new or complementary businesses, products or technologies instead of developing them ourselves, we may be unable to complete those acquisitions or to successfully integrate them in a cost-effective and non-disruptive manner.

Our success depends on our ability to continually enhance and broaden our product and service offerings in response to changing customer demands, competitive pressures and technologies. We may in the future choose to pursue collaborations or acquisitions instead of developing businesses, products or technologies ourselves. We cannot assure you, however, that we would be able to successfully complete any acquisition we choose to pursue, or that we would be able to successfully integrate any acquired business, product or technology into our company in a cost-effective and non-disruptive manner. Furthermore, there is no certainty that we would be able to attract, hire or retain key employees associated with any acquired businesses, products or technologies.

Integrating any acquired businesses, products or technologies could be expensive and time consuming, disrupt our ongoing business and divert the attention and resources of our management. If we are unable to integrate any acquired businesses, products or technologies effectively, our business will likely suffer. Additionally, any amortization of assets or charges resulting from the costs of acquisitions could negatively impact our operating results.

Our manufacturing operations and executive offices are located at a single facility that may be at risk from fire, earthquakes or other natural or man-made disasters or crises.

Our manufacturing operations and executive offices are located at a single facility in Poway, California, near known fire areas and earthquake fault zones. We have taken precautions to safeguard our facilities, including insurance and health and safety protocols. However, any future natural disaster, such as a fire or an earthquake, could cause substantial delays in our operations, damage to or destroy our manufacturing equipment or inventory, and cause us to incur additional expenses. A disaster could significantly harm our business and results of operations. The insurance we maintain against fires and other natural disasters may not be adequate to cover our losses in any particular case.

Additionally, California has experienced significant electrical power shortages and price volatility in recent years, and if our energy costs substantially increase or blackouts interrupt our power supply frequently or for more than a few days, we may have to reduce or temporarily discontinue our normal operations. Any such reduction or disruption of our operations at our facilities could harm our business.

Risks Related to Government Regulation

We must be licensed to handle and use hazardous materials and may be liable for contamination or other harm caused by hazardous materials that we use.

We use hazardous and radioactive materials in our research and development and manufacturing processes, as well as in the provision of our imaging services. We are subject to federal, state and local laws and regulations governing use, storage, handling and disposal of hazardous and radioactive materials and waste products, or hazardous materials. We are currently licensed to handle such hazardous materials in all states in which we operate, but there can be no assurances that we will be able to maintain those licenses in the future. In addition,

we must become licensed to handle hazardous materials in all states into which we plan to expand. Obtaining and maintaining those additional hazardous materials licenses is an expensive and time consuming process. If we are unable to obtain and maintain the requisite licenses, we will not be able to expand into a state and our ability to grow and become profitable will be reduced. Additionally, we cannot completely eliminate the risk of contamination or injury resulting from hazardous materials and we may incur liability as a result of any such contamination or injury. In the event of an accident, we could be held liable for damages or penalized with fines and the liability and associated legal costs could exceed our resources.

We have also incurred and may continue to incur expenses related to compliance with environmental laws. Such future expenses or liability could have a significant negative impact on our business, financial condition and results of operations. Further, we cannot assure you that the cost of complying with these laws and regulations will not materially increase in the future.

We spend considerable time and money complying with federal and state laws, regulations, and other rules, and, if we are unable to comply with such laws, regulations and other rules, we could face substantial penalties.

We are directly, or indirectly through our clients, subject to extensive regulation by both the federal government and the states in which we conduct our business, including the federal Medicare and Medicaid anti-kickback laws; other Medicare laws, regulations, rules, manual provisions, and policies that prescribe the requirements for coverage and payment for services performed by us and our DIS customers; the federal False Claims statutes; the federal Health Insurance Portability and Accountability Act of 1996, or HIPAA; the Stark Law; the federal Food, Drug and Cosmetic Act; federal and state radioactive materials laws; state food and drug and pharmacy laws and regulations; state laws that prohibit the practice of medicine by non-physicians and fee-splitting arrangements between physicians and non-physicians; state scope-of-practice laws that require either specific licenses or certifications for our personnel or their direct supervision by the site physician to perform certain tasks in the absence of such licensures or certifications; federal laws, regulations, rules and policies that permit physicians to bill and receive payment for certain diagnostic tests under the Medicare Physician Fee Schedule only if certain conditions are satisfied, including the requirement that the physician either personally perform, or adequately supervise the performance of, the tests using equipment they own or lease, and that prohibit physicians from marking up the cost of tests they "purchase," rather than perform or supervise, for Medicare patients; and state law equivalents to any of the foregoing federal laws.

We maintain a compliance program to help identify and correct any compliance issues and remain in compliance with all applicable laws, to train employees, to audit and monitor the Company's operations, to provide for a compliance hotline, and to achieve other compliance goals. Like most companies with compliance programs, we occasionally discover compliance concerns. In such cases, we take responsive action, including, when necessary, corrective measures. There can be no assurance that the Company's responsive actions will insulate us from liability associated with any detected compliance concerns.

If our past or present operations are found to be in violation of any of the laws, regulations, rules or policies described above or the other laws or regulations to which we or our customers are subject, we may be subject to civil and criminal penalties, damages, fines, exclusion from federal or state health care programs, or the curtailment or restructuring of our operations. Similarly, if our customers are found to be non-compliant with applicable laws, they may be subject to sanctions, which could have a negative impact on us. If we are excluded from federal or state health care programs, our customers who participate in those programs could not do business with us. In addition, if we are required to obtain permits or licensure that we do not possess, we may become subject to substantial additional regulation or incur significant expense. Any penalties, damages, fines, curtailment or restructuring of our operations would adversely affect our ability to operate our business and our financial results. The risk of our being found in violation of these laws is increased because many of them have not been fully interpreted by the regulatory authorities or the courts, and their provisions are open to many interpretations and additional legal or regulatory change. Any action against us for violation of these laws, even

if we successfully defend against it, could cause us to incur significant legal expenses, divert our management's attention from the operation of our business and damage our reputation.

Legislative or regulatory reform of the healthcare system may affect our ability to sell our products.

Federal and state lawmakers from time to time enact new legislation establishing significant changes in the healthcare system. Downward changes to Medicare reimbursement rates for items such as the procedures our physician clients perform or the drugs used in conjunction with them may adversely affect reimbursement to customers or potential customers that use or could use our cameras and services, and may therefore affect us. Effective January 2007, the "technical component" of Medicare reimbursement for nuclear imaging services performed in physicians' offices was capped at the lesser amount of either the Hospital Outpatient Prospective Payment System rates or the Medicare Part B Physician Fee Schedule rates. As a result of this and other reimbursement changes, the average Medicare reimbursement rate for the imaging procedures most commonly performed by our physician clients declined by 8.5% from 2006 to 2007. Other reimbursement reductions remain under consideration, and we cannot predict whether and to what extent implementation of these reductions will be delayed or whether and how the specific reimbursement rates applicable to procedures performed by our physician clients will be affected. If reimbursement reductions increase, sales of our gamma cameras would suffer and we may receive pressure from our customers to terminate or otherwise modify the lease arrangements for our DIS services. Under such circumstances, our business, financial condition and results of operations could be materially adversely affected. In addition, nuclear medicine is a "designated health service" under the federal anti-self-referral laws known as the Stark Law that a physician may not refer to an entity with which the physician or an immediate family member has a financial relationship, unless an exception applies. DIS' physician customers may be able to meet the "in-office ancillary services" exception to the Stark Law if they meet the definition of a "Group Practice" under Stark, personally supervise the individuals performing the nuclear imaging services and bill for them, and if the services are performed in the same building in which the physicians regularly practice medicine. If DIS' customers are unable or unwilling to comply with the Stark Law, utilization rates of our services and products will decline and our business will be harmed. The potential for adoption of healthcare reform proposals on a state-by-state basis could require us to develop state-specific marketing and sales approaches and adversely affect the results of operations.

Regulatory changes could have a negative impact on camera sales to and leases with hospitals desiring to use our cameras and services in their outpatient facilities.

In order for hospitals to receive certain payments for their outpatient facilities as hospital outpatient services, including services that utilize our products, these services must be furnished in a "provider-based" organization or facility, or be covered services furnished "under arrangement" with the hospital. Failure to meet these requirements may result in reduced payments to the hospitals for their services. The Medicare program has published and revised rules establishing criteria for classifying a facility as "provider-based" or a service as furnished "under arrangement." These rules require an analysis of the facts and circumstances surrounding the delivery by a hospital of a particular service, and hospitals that use our products or DIS services in their outpatient facilities will need to determine if they meet the applicable "provider-based" or "under arrangement" requirements. Hospitals that cannot obtain sufficient payments for these services may not purchase a camera from us or enter into arrangements with us for provision of services.

If we fail to comply with various licensure or certification laws, regulations or standards, we may be subject to civil, criminal and/or administrative penalties, which would adversely affect our operations.

All of the states in which we operate require that the imaging technicians operating our cameras be licensed or certified and such licensing and certification requirements are subject to change. Obtaining licenses may take significant time as we expand into additional states or if requirements change. Any lapse in the licensure or certification of our technicians could increase our costs and adversely affect our operations and financial results.

In addition, our DIS services model involves administering and furnishing radiopharmaceuticals and, until recently, pharmacological stress agents, which are regulated as drugs by state and federal agencies, including the FDA and state pharmacy boards. If a state regulatory authority determines that we have operated our business without required permits or licensure, we could be subject to civil, criminal and/or administrative penalties, including the curtailing or halting of our business. For example, in the fall of 2006, the Nuclear Regulatory Commission commenced an investigation into potential violations of regulations and licensing conditions applicable to our radioactive materials license. The investigation pertains to the submission of information by physicians seeking to gain authorized user status on our license, the delivery of radioactive material to certain individuals and the removal of radioactive materials from unlicensed sites. We believe that it is likely that the NRC will commence a proceeding at the conclusion of the investigation. In addition, an inability to obtain required licenses or permits where we currently conduct business, or in states where we plan to expand, would require us to modify the business models we can utilize in the affected jurisdictions. In either case, we could incur substantial expense and could encounter substantial operational burdens.

A number of third party payors in geographies in which we do business require physicians to obtain certain accreditations or certifications to obtain reimbursement for imaging procedures, and to meet specified privileging standards. In our DIS business, an increasing number of our customers are non-cardiologists who would not currently meet the certifications required by payors in certain geographic areas. We have obtained accreditation from the Intersocietal Commission for the Accreditation of Nuclear Medicine Laboratories for 26 of our hub locations to address certification requirements, but we cannot assure you that we will be successful in obtaining additional certifications, or that obtaining them will satisfy the requirements of these payors. If it becomes necessary for us or our customers to obtain any additional accreditations or certifications in the future, there can be no assurances that we or they will be able to obtain or continuously maintain this accreditation, and our business could be adversely affected.

Our products are subject to reporting requirements and recalls even after receiving FDA clearance or approval, which could harm our reputation, business and financial results.

We are subject to medical device reporting regulations that require us to report to the FDA or similar governmental bodies in other countries if our products cause or contribute to a death or serious injury or malfunction in a way that would be reasonably likely to contribute to death or serious injury. In addition, the FDA and similar governmental bodies in other countries have the authority to require the recall of our products in the event of material deficiencies or defects in design or manufacture that could cause adverse health consequences. A government-mandated or voluntary recall by us could occur as a result of component failures, manufacturing errors or design defects, including defects in labeling. Any recall would divert management attention and financial resources and harm our reputation with customers.

If we fail to obtain, or are significantly delayed in obtaining, FDA or foreign regulatory clearances or approvals for future products or product enhancements, or if we or our third party contractors fail to comply with FDA's Quality System Regulation, or the quality regulations of foreign governments, our ability to market and distribute our products will suffer.

Our products are subject to rigorous regulation by the FDA and numerous other federal, state and foreign governmental authorities. In the U.S., the FDA regulates virtually all aspects of a medical device's testing, manufacture, safety, labeling, storage, recordkeeping, reporting, promotion and distribution. Our failure to comply with those regulations could lead to the imposition of administrative or judicial sanctions, including Warning Letters, injunctions, suspensions or the loss of regulatory clearances or approvals, product recalls, termination of distribution, product seizures, injunctions, criminal sanctions or closure of our manufacturing facilities. The process of obtaining regulatory clearances or approvals to market a medical device can be costly and time consuming, and there can be no assurance that such clearances or approvals will be granted on a timely basis, if at all. Commercial distribution of a new medical device generally requires 510(k) clearance or an approved PMA. The FDA will clear marketing of a medical device through the 510(k) process if it is

demonstrated that the new product is substantially equivalent to a legally marketed predicate device. The PMA approval process is more costly, lengthy and uncertain than the 510(k) clearance process, and must be supported by extensive data, including data from preclinical studies and human clinical trials. We cannot assure you that we will receive marketing clearance or PMA approval for any of our new products or product enhancements, or that significant delays in the introduction of any new products or product enhancements may not occur. While we have not been required to obtain PMA approval for any of our products, we may in the future have to undergo the more lengthy, burdensome, and expensive PMA approval process. Further, pursuant to FDA regulations, we can only market our products for cleared or approved uses.

Our manufacturing processes and those of our third-party manufacturers are required to comply with the FDA's Quality System Regulation, which covers the design, testing, production processes, controls, quality assurance, labeling, packaging, storage and shipping of our devices. In addition, we must engage in extensive recordkeeping and reporting and must make available our manufacturing facility and records for periodic unscheduled inspections by federal, state and foreign agencies, including the FDA. Our failure or our third-party manufacturers' failure to pass a Quality System Regulation inspection or to comply with these and other applicable regulatory requirements could result in disruption of our operations and manufacturing delays, and a failure to take adequate corrective action could result in, among other things, Warning Letter(s), withdrawal of our medical device clearances, seizure or recall of our devices, or other civil or criminal enforcement actions.

Foreign governmental authorities that regulate the manufacture and sale of medical devices have become increasingly stringent and, to the extent we now or in the future market and sell our products in foreign countries, we may be subject to rigorous regulation by those foreign governmental authorities. In such circumstances, we would rely significantly on our foreign independent distributors to comply with the varying regulations, and any failures on their part could result in restrictions on the sale of our products in foreign countries.

Modifications to our products may require new 510(k) clearances or pre-market approvals, or may require us to cease marketing or recall the modified products until clearances are obtained.

Any modification to a 510(k)-cleared device that could significantly affect its safety or effectiveness, or that would constitute a major change in its intended use, requires a new 510(k) clearance or, possibly, approval of a PMA. The FDA requires every manufacturer to make this determination in the first instance, but the FDA may review any manufacturer's decision. The FDA may not agree with our decisions regarding whether new clearances or approvals are necessary. If the FDA requires us to seek 510(k) clearance or PMA approval for modification of a previously cleared product for which we have concluded that no clearances or approvals are necessary, we may be required to cease marketing or to recall the modified product until we obtain clearance or approval, and we may be subject to significant regulatory fines or penalties. Further, our products could be subject to recall if the FDA determines, for any reason, that our products are not safe or effective. Any recall or FDA requirement that we seek additional approvals or clearances could result in delays, fines, costs associated with modification of a product, loss of revenue and potential operating restrictions imposed by the FDA, any of which would harm our business.

Risks Related to Our Financial Results

Our quarterly and annual financial results are difficult to predict and are likely to fluctuate significantly from period to period because our business prospects are uncertain and our DIS leasing services business is seasonal.

Our revenue and results of operations at any given time will be primarily based on the following factors, many of which we cannot control:

- physician, healthcare provider and patient acceptance of our products and services;
- demand for and pricing of our products and services;
- levels of and restrictions upon third-party payor reimbursement for our products and services;

- accreditation and credentialing requirements imposed by third-party payors on physicians and providers of mobile imaging services;
- our ability to retain our DIS customers;
- success and timing of new product offerings, acquisitions, licenses or other significant events by us or our competitors;
- camera purchases by DIS customers;
- our ability to establish and maintain a productive manufacturing, marketing, sales and distribution force;
- the ability of our suppliers to provide us with an adequate supply of necessary components on a timely basis;
- timing and magnitude of our expenditures;
- our ability to reduce our expenses quickly enough to respond to any declines in revenue;
- regulatory approvals and legislative changes affecting the products we may offer or those of our competitors;
- the effect of competing technological and market developments; and
- interruption in the manufacturing or distribution of our products and services.

Furthermore, we have experienced seasonality in the leasing services offered by DIS. While our physicians are obligated to pay us for all lease days to which they have committed, our contracts permit some flexibility in scheduling when services are to be performed. This accounts for some of the seasonality of our DIS revenues. We cannot predict with certainty the degree to which seasonal circumstances such as the summer slowdown, winter holiday variations and weather conditions may make our revenue unpredictable or lead to fluctuations in our quarterly operating results in the future.

In addition, due to the way that customers in our target markets acquire our products, a large percentage of our orders of cameras is booked during the last month of each quarterly accounting period. As such, a delivery delay of only a few days may significantly impact our quarter-to-quarter comparisons Moreover, the sales cycle for our cameras is typically lengthy, which may cause us to experience significant revenue fluctuations.

For these reasons, quarterly and annual sales and operating results may vary significantly in the future and period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indicators of future performance. We cannot assure you that our sales will increase or be sustained in future periods. We have experienced, and may continue to experience, significant, unanticipated quarterly and annual losses. Because of these and other factors, our operating results in one or more future reporting period may fail to meet the expectations of securities analysts or investors, which could cause our stock price to decline significantly.

We have incurred significant and recurring operating losses since our inception in 1985 and we may incur such losses and increased operating expenses in the near term.

We have incurred significant cumulative net losses since our inception in November 1985 and may incur such losses and increased operating expenses in the near term as we, among other things:

- expand our DIS business;
- increase marketing, sales and distribution of our current products; and
- conduct research and development to develop next-generation products and to enhance our existing products.

As a result of these activities, we may not be able to become profitable or, if we do, maintain profitability. If our revenue grows more slowly than anticipated, or if our operating expenses exceed our expectations, our ability to achieve our development and expansion goals would be adversely affected.

Risks Related to Our Intellectual Property and Potential Litigation

Our ability to protect our intellectual property and proprietary technology through patents and other means is uncertain.

Our success depends significantly on our ability to protect our proprietary rights to the technologies used in our products. We rely on patent protection, as well as a combination of copyright, trade secret and trademark laws, and nondisclosure, confidentiality and other contractual restrictions to protect our proprietary technology. However, these legal means afford only limited protection and may not adequately protect our rights, be enforceable or permit us to gain or keep any competitive advantage. Our pending U.S. and foreign patent applications, which include claims to material aspects of our products and procedures that are not currently protected by issued patents, may not issue as patents in a form that will be advantageous to us. Any patents we have obtained or do obtain may be challenged by re-examination or otherwise invalidated or eventually found unenforceable. Both the patent application process and the process of managing patent disputes can be time consuming and expensive. Competitors may attempt to challenge or invalidate our patents, or may be able to design alternative techniques or devices that avoid infringement of our patents, or develop products with functionalities that are comparable to ours.

In the event a competitor infringes upon our patent or other intellectual property rights, litigation to enforce our intellectual property rights or to defend our patents against challenge, even if successful, could be expensive and time consuming and could require significant time and attention from our management. We may not have sufficient resources to enforce our intellectual property rights or to defend our patents against challenges from others.

The medical device industry is characterized by patent litigation and we could become subject to litigation that could be costly, result in the diversion of our management's time and efforts, and require us to pay damages.

Any litigation or claims against us, or claims we bring against others, may cause us to incur substantial costs, could place a significant strain on our financial resources, divert the attention of our management from our core business and harm our reputation. If the relevant patents were upheld as valid and enforceable and we were found to be inadvertently infringing, we could be required to pay substantial damages and/or royalties and could be prevented from selling our products unless we could obtain a license or were able to redesign our system to avoid infringement. Any such license may not be available on reasonable terms, if at all. If we fail to obtain any required licenses or make any necessary changes to our products or technologies, we may be unable to commercialize one or more of our products, which could severely harm our business.

We may be subject to damages resulting from claims that we, or our employees, have wrongfully used or disclosed alleged trade secrets of their former employers.

Many of our employees were previously employed at other medical device companies, including our competitors or potential competitors. Although no claims against us are currently pending, we may be subject to claims that we or our employees have inadvertently or otherwise used or disclosed trade secrets or other proprietary information of their former employers. Litigation may be necessary to defend against these claims. Even if we are successful in defending against these claims, litigation could result in substantial costs and be a distraction to management. If we fail in defending such claims, in addition to paying money damages, we may lose valuable intellectual property rights or personnel. A loss of key research personnel or their work product could hinder or preclude our ability to commercialize our products, which could severely harm our business.

Risks Related to the Securities Markets and Ownership of Our Common Stock

Our stock price may be volatile.

The market price for our common stock has been and is likely to continue to be volatile. In addition, the market price of our common stock may fluctuate significantly in response to a number of factors, most of which we cannot control, including:

- volume and timing of orders for our products and services;
- declining sales of nuclear imaging products and other adverse conditions affecting our target markets;
- the results of delays in introduction of new products, product enhancements, services or technologies by us or our competitors;
- period-to-period variations in our or our competitors' results of operations;
- conditions or trends in the medical device industry and the imaging service industry;
- disputes or other developments with respect to intellectual property rights, product liability claims or other litigation;
- our ability to develop, obtain regulatory clearance for, and market, new and enhanced products on a timely basis, or changes in governmental regulations or in the status of our regulatory approvals or applications;
- additions or departures of key personnel;
- sales of large blocks of our common stock, including sales by our executive officers and directors;
- changes in the availability of third-party reimbursement in the United States or other countries;
- changes in earnings estimates or recommendations by securities analysts; and
- general market conditions and other factors, including factors unrelated to our operating performance or the operating performance of our competitors.

Future sales of our common stock may cause our stock price to decline.

A small number of our current stockholders hold a substantial number of shares of our common stock that they may sell in the public market. Sales by our current stockholders of a substantial number of shares, or the expectation that such sale may occur, could significantly reduce the market price of our common stock. Moreover, the holders of a substantial number of our shares of common stock, including shares issued upon the exercise of certain of our warrants, have rights, subject to some conditions, to require us to file registration statements to permit the resale of their shares in the public market or to include their shares in registration statements that we may file for ourselves or other stockholders. We have also registered all common stock that we may issue under our employee benefit plans. Accordingly, these shares can be freely sold in the public market upon issuance, subject to restrictions under the securities laws and the lock-up agreements described above. If any of these stockholders cause a large number of securities to be sold in the public market, the sales could reduce the trading price of our common stock. These sales also could impede our ability to raise future capital.

Our common stock is thinly traded and an active trading market may not be sustained.

Although we are currently listed for trading on the Nasdaq National Market, an active trading market for our common stock may not be sustained. An inactive market may impair your ability to sell your shares at the time you wish to sell them or at a price that you consider reasonable. Furthermore, an inactive market may impair our ability to raise capital by selling shares and may impair our ability to acquire other businesses, products and technologies by using our shares as consideration.

Anti-takeover provisions in our organizational documents, our Stockholders Rights Plan and Delaware law may prevent or delay removal of current management or a change in control.

Our restated certificate of incorporation and restated bylaws contain provisions that may delay or prevent a change in control, discourage bids at a premium over the market price of our common stock and adversely affect the market price of our common stock and the voting and other rights of the holders of our common stock. These provisions include:

- prohibiting our stockholders from calling a special meeting of stockholders unless they hold not less than 20% of the total number of votes to be cast at such a meeting;
- permitting the issuance of additional shares of up to 10,000,000 shares of preferred stock without stockholder approval upon terms and conditions, and with the rights, preferences and privileges as a board of directors may determine;
- prohibiting our stockholders from making certain changes to our restated certificate of incorporation or restated bylaws except with 66 2/3% stockholder approval; and
- requiring advance notice for raising matters of business or making nominations at stockholders' meetings.

The rights issued pursuant to our Stockholder Rights Plan will become exercisable, subject to certain exceptions, the tenth day after a person or group announces acquisition of 15% or more of our common stock or announces commencement of a tender or exchange offer the consummation of which would result in ownership by the person or group of 15% or more of our common stock.

In addition, as a Delaware corporation, we are subject to Delaware law, including Section 203 of the Delaware General Corporation Law. In general, Section 203 prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years following the date that the stockholder became an interested stockholder unless certain specific requirements are met as set forth in Section 203.

These provisions alone or together, could have the effect of deterring or delaying changes in incumbent management, proxy contests or changes in control.

If our officers, directors and principal stockholders choose to act together, they may be able to control our management and operations, acting in their best interests and not in the best interests of other stockholders.

Our officers, directors and holders of 5% or more of our outstanding common stock beneficially own a significant amount of our outstanding common stock. As a result, these stockholders, acting together, will be able to significantly influence all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combination transactions. The interests of this group of stockholders may not always coincide with our interests or the interests of other stockholders, and they may act in a manner that advances their best interests and not necessarily those of other stockholders. As a result of their actions or inactions our stock price may decline.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

Our product and DIS operations are headquartered in an approximately 70,000 square foot facility in Poway, California that is leased to us until February 2010. We believe that our existing facility is adequate for our current needs. In addition, DIS leases approximately 47 small hub locations in the various states in which we operate, which primarily house our fleet of cameras and vans. The lease terms typically range between two and four years.

Item 3. Legal Proceedings

In the normal course of business, we have been and will likely continue to be subject to litigation or administrative proceedings incidental to our business, such as claims related to customer disputes, employment practices, wage and hour disputes, product liability, professional liability, commercial disputes, licensure restrictions or denials, and warranty or patent infringement. Responding to litigation or administrative proceedings, regardless of whether they have merit, can be expensive and disruptive to normal business operations. As litigation and the administrative proceedings are inherently uncertain, we cannot predict the outcome of such matters. We can provide no assurance that the ultimate outcome, either individually or in the aggregate, will not have a material adverse effect on our business or financial results.

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

None

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

Our common stock has been traded on the NASDAQ National Market since June 10, 2004 under the symbol DRAD. Prior to such time, there was no public market for our common stock. The following table sets forth the high and low closing sales prices for our common stock as reported on the NASDAQ National Market for the periods indicated.

Year Ended December 31, 2005	High	Low
First Quarter	$ 8.85	$ 7.25
Second Quarter	7.59	5.00
Third Quarter	5.96	4.47
Fourth Quarter	4.92	3.55

Year Ended December 31, 2006	High	Low
First Quarter	$ 4.43	$ 3.59
Second Quarter	5.29	3.90
Third Quarter	4.87	3.58
Fourth Quarter	4.23	3.30

As of February 6, 2007, there were approximately 226 holders of record of our common stock.

Dividend Policy

We have never declared or paid cash dividends on our capital stock. We currently intend to retain all available funds and any future earnings for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future.

Use of Proceeds

We effected the initial public offering of our common stock pursuant to a Registration Statement on Form S-1 (File No. 333-113760) that was declared effective by the Securities and Exchange Commission on June 9, 2004.

Sales of Unregistered Securities

None.

Repurchases of Equity Securities

We did not repurchase any shares of our common stock during the fiscal quarter ended December 31, 2006.

Equity Compensation Plans Information

The information required by this item will be contained in our definitive proxy statement to be filed with the Securities and Exchange Commission in connection with the Annual Meeting of our Stockholders, which is expected to be filed not later than 120 days after the end of our fiscal year ended December 31, 2006 (the "Proxy Statement"), and is incorporated in this report by reference.

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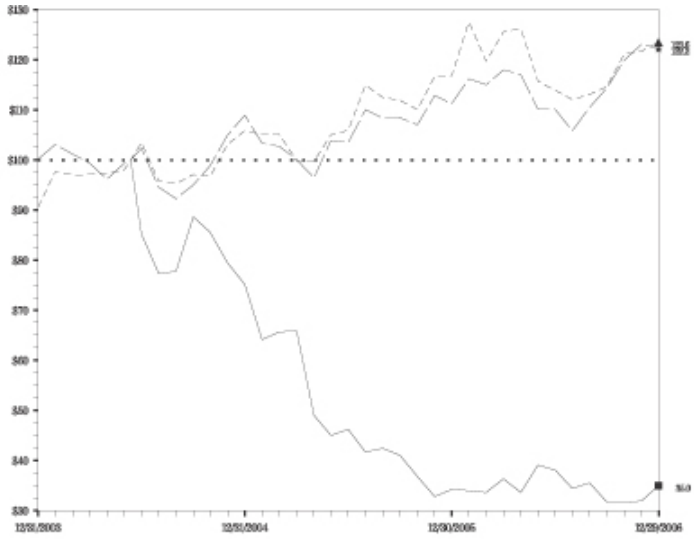
Performance Graph

The following performance graph illustrates a comparison of total cumulative stockholder return on our common stock since June 10, 2004, the date of out initial public offering, to two indices: (i) the Center for Research in Security Prices ("CRSP") Total Return Index for the Nasdaq Stock Market and (ii) a peer group industry index based on the standard industrial code for surgical medical and dental instruments and supplies ("Peer Group Index"). The graph assumes an initial investment of $100 on June 10, 2004 and that all dividends have been reinvested. No cash dividends have been declared on our common stock. The comparisons in the graph are required by the Securities and Exchange Commission and are not intended to forecast or be indicative of possible future performance of our common stock.

Comparison of Five-Year Cumulative Total Returns
Performance Graph for
Digirad Corporation

Produced on 02/05/2007 including data to 12/29/2006



Legend

Symbol	CRSP Total Returns Index for:	12/2004	12/2005	12/2006
■	Digirad Corporation	75.2	34.2	35.0
★	Nasdaq Stock Market (US Companies)	108.9	111.3	122.2
▲	NASDAQ Stocks (SIC 3840-3849 US Companies) Surgical, Medical, and Dental Instruments and Supplies	105.9	116.8	123.6

Notes:
A. The lines represent monthly index levels derived from compounded daily returns that include all dividends.
B. The indexes are reweighted daily, using the market capitalization on the previous trading day.
C. If the monthly interval, based on the fiscal year-end, is not a trading day, the preceding trading day is used.
D. The index level for all series was set to $100.0 on 06/09/2004.

Item 6. Selected Consolidated Financial Data

The following selected financial data should be read in conjunction with our Consolidated Financial Statements and related disclosures and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" which are included elsewhere in this Form 10-K. Amounts are presented in thousands, except per share amounts.

	Years Ended December 31,				
	2006	2005	2004	2003	2002
Statement of Operations Data:					
Revenues:					
DIS	$49,614	$ 50,194	$44,505	$ 34,848	$ 23,005
Product	22,312	17,992	23,632	21,388	18,527
Total revenues	71,926	68,186	68,137	56,236	41,532
Cost of revenues:					
DIS	37,675	37,376	31,221	24,494	16,651
Product	15,192	15,564	15,157	15,174	13,705
Total cost of revenues	52,867	52,940	46,378	39,668	30,356
Gross profit	19,059	15,246	21,759	16,568	11,176
Operating expenses:					
Research and development	3,894	3,747	3,115	2,199	3,028
Sales and marketing	8,827	7,420	7,762	6,026	8,293
General and administrative	14,535	14,903	10,236	8,183	9,691
Amortization and impairment of intangible assets	27	179	64	444	1,011
Total operating expenses	27,283	26,249	21,177	16,852	22,023
Income (loss) from operations	(8,224)	(11,003)	582	(284)	(10,847)
Other income (expense), net	1,934	1,384	(337)	(1,396)	(1,925)
Net income (loss)	$ (6,290)	$ (9,619)	$ 245	$ (1,680)	$ (12,772)
Net income (loss) applicable to common stockholders	$ (6,290)	$ (9,619)	$ 84	$ (2,006)	$ (13,037)
Basic and diluted net income (loss) per share (1):	$ (0.34)	$ (0.52)	$ 0.01	$(127.62)	$(1,432.31)
Shares used in per share calculations (1):					
Basic	18,761	18,468	10,095	16	9
Diluted	18,761	18,468	16,963	16	9

	As of December 31,				
	2006	2005	2004	2003	2002
Balance Sheet Data:					
Cash, cash equivalents and securities	$44,326	$ 49,505	$55,563	$ 7,681	$ 6,988
Working capital	45,788	50,660	59,015	2,578	3,781
Total assets	69,277	74,504	86,024	35,159	33,119
Total debt	368	1,134	3,982	16,441	13,932
Redeemable convertible preferred stock	—	—	—	84,278	83,952
Total stockholders' equity (deficit)	55,445	59,988	68,734	(75,703)	(73,928)

(1) As a result of the conversion of our preferred stock into 12.4 million shares of our common stock upon completion of our initial public offering in June 2004, there is a lack of comparability in the basic and diluted net income (loss) per share amounts for the periods presented above. Please refer to Note 1 to our consolidated financial statements included elsewhere in this Form 10-K for the calculation of pro forma basic and diluted net income (loss) per share presented therein.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion contains forward-looking statements, which involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth previously under the caption "Risk Factors." This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this report.

Overview

We are a leading provider of cardiovascular imaging services and solid-state nuclear medicine imaging products to physician offices, hospitals and imaging centers. We designed and commercialized the first solid-state nuclear gamma camera for the detection of cardiovascular disease and other medical conditions. Our imaging systems are mobile as well as fixed and provide enhanced operability, improved patient comfort and, in the case of our triple-headed Cardius®-3 XPO system, shorter image acquisition time, when compared to traditional vacuum tube cameras. The cameras and accompanying equipment fit easily into floor spaces as small as seven feet by eight feet and facilitate the delivery of nuclear medicine procedures in a physician's office, an outpatient hospital setting or within multiple departments of a hospital.

2006 Highlights

Our consolidated revenues were $71.9 million in 2006, which represented an increase of 5.5% over 2005 attributable to growth in our product business. In DIS, revenue decreased 1.2% to $49.6 million, and in the product business, revenue increased 24.0% to $22.3 million. As discussed in previous filings, beginning in June 2006, DIS phased out providing stress agents used in some imaging procedures. As a result, we recognized $2.0 million of stress agent revenue in 2006 compared to $4.2 million recognized in 2005. As of December 31, 2006, our DIS segment operated in 23 states and the District of Columbia. Our DIS business performed 13,558 service days during 2006 compared to 13,711 service days during 2005, and we performed more than 100,000 studies in 2006 as compared to 98,000 studies in 2005. Revenue per day was essentially unchanged at $3,659 for 2006 compared to $3,661 for 2005. Excluding stress agent revenue we received through approximately mid-2006, revenue per day for 2006 was $3,508. Our DIS gross margins in 2006 decreased to 24.1% compared to 25.5% in 2005, due primarily to an additional $0.7 million of personnel costs previously recorded in general and administrative expenses. The additional personnel costs are now included in costs of revenues as the focus and responsibilities of these personnel has shifted towards increased operational as opposed to administrative tasks.

During 2006, we increased the number of mobile cameras we operate from 80 to 83. As part of our plan to upgrade our DIS camera fleet over the next few years, we placed 19 triple-headed cameras into our DIS business in 2006. We also closed four unprofitable hubs, negotiated additional supply cost savings, automated various processes to improve our insight into hub and customer profitability, and signed our first ultrasound imaging services contract. We obtained additional hub accreditation to respond to the reimbursement requirements of some third party payors. As of December 31, 2006, we obtained accreditation from the Intersocietal Commission for the Accreditation of Nuclear Medicine Laboratories for 26 of our DIS hub locations.

During 2006, our product business delivered 71 gamma cameras compared to 55 cameras during 2005. Product gross margins improved to 31.9% 2006 compared to 13.5% during 2005, due primarily to the delivery of 16 more cameras and improved margins on our camera service and maintenance contracts. In the summer of 2006, we launched our new triple-headed Cardius-3 XPO camera, designed to provide improved image quality, high patient throughput, a lower cost structure and increased reliability and serviceability. The camera can image patients weighing up to 500 pounds and includes our latest image acquisition and processing software. We anticipate releasing the Cardius-1 and Cardius-2 cameras with the XPO features and benefits in the first part of 2007.

Stock-based compensation costs increased $1.1 million to $1.6 million for 2006 compared to 2005 as the result of the adoption of a new accounting principle. Overall, we ended the twelve months of 2006 with a consolidated net loss of $6.3 million, as compared to a net loss of $9.6 million for the twelve months of 2005.

Our Market

The target market for our products and services is comprised of approximately 26,000 cardiologists, the larger practices among the 130,000 internists and family practitioners, and hospitals in the United States that perform or could perform nuclear cardiac procedures. We estimate that there are approximately 8,000 internist practices with more than four internists. As of December 31, 2006, we have provided imaging services through DIS to approximately 561 physicians and physician groups, the majority of which are cardiologists, and have sold 457 cameras to customers through our product segment.

According to IMV Medical Information, U.S. procedure volume in nuclear medicine (excluding PET studies) grew by 15% between 2002 and 2005 to an estimated 19.7 million nuclear imaging procedures in 2005, of which some 11.2 million were cardiovascular-specific procedures. The National Electrical Manufacturers Association, or NEMA, estimates that sales of general nuclear imaging equipment declined approximately 10% during 2006.

We believe our market has been negatively affected by declining reimbursement, significant pricing pressures in the product business, and continuing efforts by some third party payors to reduce health care expenditures by requiring physicians to obtain specific accreditations or certifications, or disallowing reimbursement if imaging is performed with mobile or leased cameras. A number of smaller companies have recently begun to market mobile nuclear imaging cameras for cardiac applications, and we believe competition from local or regional companies providing mobile imaging services has increased. We expect each of these trends to continue.

Revenue Sources

We generated revenues within two primary operating segments: our DIS business and product sales business. Through DIS, we offer a comprehensive and mobile imaging services leasing program as an alternative to purchasing a gamma camera for physicians who wish to perform nuclear imaging procedures in their offices by leasing the imaging system, certified personnel and other support required to perform nuclear imaging in the physician office. The flexibility of our products and our DIS leasing service allows physicians more control over the diagnosis and treatment of their patients in their offices and to retain revenue from procedures they would otherwise refer elsewhere. We also offer DigiTech leases to customers who own one of our cameras but wish us to provide staffing and other support services. DIS leasing services are primarily provided to cardiologists and internists. Physicians enter into annual contracts for imaging services delivered on a per-day basis. Our typical lease contracts provide service coverage ranging from once per month to three times per week, adjusted for holidays and vacations. We experience some seasonality in our DIS business related to summer slowdowns (principally relating to vacations), holidays and inclement weather. Historically, the DIS results have been most affected by seasonality in the third quarter.

Our product revenue results primarily from selling solid-state gamma cameras and other ancillary items, and from our camera maintenance contracts. We sell our imaging systems to physician offices, hospitals and imaging centers primarily in the United States, although we have sold a small number of imaging systems internationally. We do not anticipate that the international market will be a significant source of revenues in the foreseeable future. Despite the general decline in the nuclear cardiology market, our product business delivered 71 cameras in 2006 compared to 55 cameras in 2005. Our new Cardius XPO camera series allows physicians to choose among single, dual or triple-head cameras to accommodate their practices' speed and throughput needs, or to upgrade a single head camera to a dual or triple head configuration as their practice grows or changes.

Trends and Drivers

Our DIS business in 2006 was able to attract a larger number of new customers, some of whom were larger, multi-specialty practices. Integrated delivery networks, hospital outreach programs and multi-location practices expressed increased interest in our DIS leasing services. Further, we signed our first contract for the delivery of ultrasound imaging services. We believe these trends will continue in 2007.

The number of DIS physicians who purchased their own cameras or switched to a different service provider increased during the second half of 2006. Medicare reimbursement for 2007 will decline by approximately 8.5% over 2006 for the imaging procedures most often performed by our physician customers. In addition, a greater number of third party payors adopted guidelines that would prohibit reimbursement for certain imaging procedures performed with mobile or leased equipment or by unaccredited facilities. We plan to continue our efforts to obtain accreditation for our DIS hub locations in 2007.

In the product business, industry sources predict that the rate of decline of sales of cardiac-specific nuclear camera will slow from an estimated 24% to approximately 5% in 2007, and that purchases of multi-head cameras will far outpace those of single-head cameras. During 2006, we believe we were able to expand our market share and we will continue to invest in research and development to improve the image quality, speed, reliability, cost structure and overall performance of our multi-headed cameras and software to enable us to capture an increasing share of the gamma camera market. However, we continue to experience pricing pressures on the majority of our cameras. The hospital market has expressed a renewed interest in our general purpose single-head camera, and we expect to continue to sell more cameras into this market in 2007.

Our camera maintenance margins have improved as the number of cameras under contract grew and our service logistics have become more efficient, and we believe these improvements will continue in 2007.

Results of Operations

The following table sets forth our results from operations, expressed as percentages of total revenues for the years ended December 31, 2006, 2005 and 2004:

	2006	2005	2004
Revenues:			
DIS	69.0%	73.6%	65.3%
Product	31.0	26.4	34.7
Total revenues	100.0	100.0	100.0
Total cost of revenues	73.5	77.6	68.1
Gross profit	26.5	22.4	31.9
Operating expenses:			
Research and development	5.4	5.5	4.6
Sales and marketing	12.3	10.8	11.4
General and administrative	20.2	21.9	15.0
Amortization and impairment of intangible assets	0.0	0.3	0.1
Total operating expenses	37.9	38.5	31.1
Income (loss) from operations	(11.4)	(16.1)	0.8
Other income (expense)	2.7	2.0	(0.6)
Accretion of deferred issuance costs on preferred stock	—	—	(0.2)
Net income (loss) applicable to common stockholders	(8.7)%	(14.1)%	— %

Comparison of Years Ended December 31, 2006 and 2005

Revenues

Consolidated. Consolidated revenues were $71.9 million in 2006, which represents an increase of $3.7 million, or 5.5% over the prior year, primarily as a result of delivering 16 more cameras in 2006 as compared to 2005 and an increase in camera service and maintenance contract revenue. DIS and product revenue accounted for 69.0% and 31.0%, respectively, of total revenues for 2006, compared to 73.6% and 26.4%, respectively, for 2005. We expect DIS revenue to continue to represent the larger percentage of our consolidated revenue in future periods.

DIS. Our DIS revenue decreased to $49.6 million for 2006, which represents a decline of $0.6 million, or 1.2%, over the prior year. The decrease in DIS revenue resulted primarily from phasing out the delivery of stress agents to the majority of our DIS customers in June 2006. Stress agent revenue was $0.1 million for the last seven months of 2006 compared to $2.4 million for the comparable prior year period. We anticipate that our DIS revenue will increase as we expand into new markets and continue to penetrate existing markets. Such growth will fluctuate, however, based on seasonality stemming from physician vacations, holidays, inclement weather and start up time required by sales representatives as we enter new geographical areas.

Product. Our product revenue was $22.3 million for 2006, representing an increase of $4.3 million, or 24.0%, over the prior year. The increase in product revenue is due to selling 71 cameras in 2006 compared to 55 in 2005, resulting in $2.2 million of additional revenues, and an increase in camera service and maintenance contract revenues of nearly $2.1 million. Maintenance contract revenues were $7.4 million in 2006 compared to $5.3 million in 2005. We continue to experience pricing pressures on our gamma cameras and we expect this pricing pressure to continue.

Gross Profit

Consolidated. Consolidated gross profit was $19.1 million for 2006, representing an increase of $3.8 million or 25.0%, compared to 2005. The increase in consolidated gross profit is principally due to the improved performance of our Product segment in 2006 as compared to 2005. Consolidated gross profit as a percentage of revenue increased to 26.5% in 2006 from 22.4% in 2005.

DIS. Cost of DIS revenue consists primarily of labor, radiopharmaceuticals, equipment depreciation and other costs associated with the provision of services. Cost of DIS revenue was $37.7 million in 2006, representing an increase of $0.3 million, or 0.8%, over 2005, primarily resulting from the additional personnel costs of employees previously categorized in general and administrative expenses whose duties have been shifted towards operations. DIS gross profit as a percentage of revenue decreased to 24.1% in 2006 from 25.5% in 2005. DIS gross profit decreased to $11.9 million for 2006, a decrease of $0.9 million, or 6.9%.

Product. Cost of revenues primarily consists of materials, labor and overhead costs associated with the manufacturing and warranty of our products. Warranty costs are charged to cost of revenues in the period our cameras are sold and are based on our historical experience with failure rates and repair costs. Cost of revenues was $15.2 million in 2006, a decrease of $0.4 million, or 2.4%, compared to 2005. Product gross profit as a percentage of revenue increased to 31.9% in 2006 from 13.5% in 2005. Product gross profit increased to $7.1 million in 2006, an increase of $4.7 million, or 193.2%, mainly as a result of the delivery of 16 more cameras in 2006 as compared to 2005, or $3.4 million, and improved margins on our camera service and maintenance contracts of $1.5 million.

Operating Expenses

Research and Development. Research and development expenses consist primarily of costs associated with the design, development, testing, and enhancement of our products. The primary costs are salaries and fringe benefits, development material costs, facility and overhead costs, consulting fees and nonrecurring engineering costs. Research and development expenses increased to $3.9 million in 2006, an increase of $0.1 million, or 3.9%, over 2005. This was primarily attributable to increased spending on new product development, including a mobile version of our Cardius-3 XPO triple-head camera and our software development initiatives. Research and development related stock-based compensation costs, including those associated with the adoption of SFAS 123(R), were $0.1 million during 2006. Research and development expenses were 5.4% of total revenues for 2006 versus 5.5% for 2005. Our research and development efforts occur principally within our products segment. In the future, we expect to continue to invest in research and development as we innovate and seek to continue to improve our existing technology.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries, commissions, bonuses, travel, marketing and collateral materials and tradeshow costs. Sales and marketing expenses increased to $8.8 million in

2006, an increase of $1.4 million, or 19.0%, over 2005, primarily as a result of an increase in personnel costs of $0.8 million. Sales and marketing related stock-based-compensation costs, including those associated with the adoption of SFAS 123(R), were $0.3 million during 2006, which was $0.2 million higher than the stock-based compensation costs recorded in 2005. Sales and marketing expenses were 12.3% of total revenue in 2006 compared to 10.8% in 2005. We expect to increase our sales and marketing efforts as we expand into new geographies and launch a marketing program for echocardiography and vascular ultrasound.

General and Administrative. General and administrative expenses consist primarily of salaries and other related costs for finance and accounting, human resources and other personnel, as well as legal and other professional fees and insurance. General and administrative expenses were $14.5 million in 2006, representing a decrease of $0.4 million, or 2.5%, over 2005. Stock-based compensation costs, including those associated with the adoption of SFAS 123(R), were $1.0 million during 2006, which was $0.7 million higher than the stock-based compensation costs recorded in the 2005. General and administrative expenses were 20.2% of total revenue in 2006 compared to 21.9% in 2005.

Stock-based compensation

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), “Share-Based Payment”, which is a revision of Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation” using the modified prospective method, which requires measurement of compensation of all stock-based awards at fair value on the date of grant and recognition of compensation over the service period for awards expected to vest. Under this method, the provisions of SFAS 123(R) apply to all awards granted or modified after the date of adoption. In addition, the unrecognized expense of awards not yet vested at the date of adoption, determined under the original provisions of SFAS 123, shall be recognized in net income in the periods after adoption. The fair value of options is determined using the Black-Scholes valuation model, which is consistent with valuation techniques previously utilized for options in footnote disclosures required under SFAS 123. Such value is recognized as expense over the service period, net of estimated forfeitures, using the straight-line method under SFAS 123(R).

Prior to the adoption of SFAS 123(R), we applied APB Opinion No. 25, “Accounting for Stock Issued to Employees” and related Interpretations, in accounting for our equity plans. Deferred compensation for stock options granted to employees was determined as the difference between the exercise price and the fair value of our common stock on the date of grant. Those amounts were initially recorded as a component of stockholders’ equity and were amortized, on an accelerated basis, as a non-cash charge to cost of revenues and operations over the vesting period of the options.

The adoption of SFAS 123(R) in 2006 resulted in the recognition of total stock-based compensation expense of $1.6 million in 2006. Of this amount, approximately $0.2 million is included in cost of sales, $0.1 million is included in research and development expenses, $0.3 million is included in selling and marketing expenses and $1.0 million is included in general and administrative expenses. Total unrecognized stock-based compensation costs related to nonvested stock and option awards at December 31, 2006 is $2.2 million which arose from the adoption of SFAS No. 123(R). The unrecognized cost is expected to be recognized over a weighted average period of approximately 2.0 years.

Other Income (Expense)

Other income (expense) consists primarily of interest income, net of interest and other expenses. The increase during 2006 from 2005 reflects an increase in market yields on our cash and investment balances and a $0.1 million reduction of interest expense as a result of the reduction of amounts outstanding on capital leases.

Net Loss

Our net loss for the year ended December 31, 2006 decreased to $6.3 million compared to $9.6 million loss for the year ended December 31, 2005, primarily as a result of the factors described above.

Comparison of Years Ended December 31, 2005 and 2004

Revenues

Consolidated. Consolidated revenues were $68.2 million in 2005, which was essentially unchanged from the prior year, as the increase in demand for our DIS imaging services offset the decrease in revenue product revenue. We believe that the increase in demand for our DIS imaging services was principally a result of continued increase in physician awareness and acceptance of our services, primarily by internists. DIS and product revenue accounted for 73.6% and 26.4%, respectively, of total revenues in 2005, compared to 65.3% and 34.7%, respectively, in 2004.

DIS. Our DIS revenue increased to $50.2 million in 2005, an increase of $5.7 million, or 12.8%. The increase in DIS revenue resulted from an increase in the number of DIS service days to 13,711 in 2005 from 12,003 for 2004, primarily attributable to an increase in the number of physicians entering into our DIS services contracts and an increase in the retention of current DIS customers. We deployed nine additional systems during 2005. Our DIS business operated 80 mobile and fixed site systems as of December 31, 2005.

Product. Our product revenue decreased to $18.0 million in 2005, a decrease of $5.6 million, or 23.9% compared to 2004. The decrease in product revenue is attributable to a decline in the sales of gamma cameras resulting primarily from management vacancies in the sales organization, underperforming sales representatives and a decline in the number of single head cameras sold. Maintenance contract revenues were $5.2 million in 2005 and $3.4 million in 2004.

Gross Profit

Consolidated. Consolidated gross profit decreased to $15.2 million in 2005, a decrease of $6.5 million or 29.9%. The decrease in consolidated gross profit is primarily attributable to the decline in the number of gamma cameras sold during 2005, a decline in staff productivity and DIS system utilization, a fourth quarter expense of approximately $1.0 million resulting from the change in the depreciable life of our DIS camera fleet from seven years to five years, unfavorable variances attributable to a reduction in production volumes in the third quarter of 2005, resulting in excess capacity costs of $0.7 million and inventory-related charges of $0.6 million recorded in the second quarter of 2005. Consolidated gross profit as a percentage of revenue decreased to 22.4% in 2005 from 31.9% in 2004.

DIS. Cost of DIS revenue increased to $37.4 million in 2005, an increase of $6.2 million, or 19.7%, primarily as a result of an increase in the number of DIS leasing days resulting from new contracts with new physicians. DIS gross profit decreased to $12.8 million in 2005, a decrease of $0.5 million, or 3.5%. DIS gross profit as a percentage of revenue decreased to 25.5% in 2005 from 29.8% in 2004. The decline in DIS gross profit as a percentage of revenue is primarily a result of the approximately $1.0 million depreciation charge in the fourth quarter of 2005 discussed above and a decline in staffing productivity and system utilization.

Product. Cost of revenues increased to $15.6 million in 2005, an increase of $0.4 million, or 2.7%. Product gross profit decreased to $2.4 million in 2005, a decrease of $6.0 million, or 71.4%, primarily as a result of a decline in the number of gamma cameras sold and the unfavorable production variances and inventory charges, primarily incurred in the second and third quarters of 2005. Product gross profit as a percentage of revenue decreased to 13.5% in 2005 from 35.9% in 2004.

Operating Expenses

Research and Development. Research and development expenses were $3.7 million in 2005, which represents an increase of $0.6 million, or 20.3%. This increase was primarily attributable to increased spending on new product development, including a mobile version of our Cardius-3 triple-head camera. Research and development expenses were 5.5% of total revenue in 2005 compared to 4.6% for 2004.

Sales and Marketing. Sales and marketing expenses were $7.4 million in 2005, which represents a decrease of $0.3 million or 4.4%, primarily as a result of a reduction of variable compensation associated with camera sales. Sales and marketing expenses were 10.8% of total revenue in 2005 compared to 11.4% for 2004.

General and Administrative. General and administrative expenses were $14.9 million in 2005, representing an increase of $4.7 million, or 45.6%. Increases in headcount, recruiting costs, professional fees, legal costs, costs related to our internal control efforts to comply with Section 404 of the Sarbanes-Oxley Act and other costs related to operating as a public company all contributed to increased general and administrative expenses. General and administrative expenses were 21.9% of total revenue in 2005 compared to 15.0% for 2004.

Amortization and Impairment of Intangible Assets. Amortization and impairment of intangibles increased to $0.2 million in 2005 from $0.1 million in 2004.

Stock-Based Compensation Charges. Deferred compensation for stock options granted to employees was determined as the difference between the exercise price and the fair value of our common stock on the date of grant. Options or awards issued to non-employees was recorded at their fair value in accordance with SFAS No. 123 and periodically remeasured in accordance with EITF 96-18 and recognized over the respective service or vesting period. These amounts were initially recorded as a component of stockholders' equity and were amortized, on an accelerated basis, as a non-cash charge to cost of revenues and operations over the vesting period of the options. In connection with the grant of stock options to employees, we recorded amortization of stock-based compensation of $0.5 million and $1.1 million in 2005 and 2004, respectively.

Other Income (Expense)

Interest income increased to $1.7 million in 2005 from $0.6 million in 2004, primarily due to higher average cash and investment balances in 2005 as a result of our initial public offering, which closed in June 2004. Interest expense decreased to $0.2 million in 2005 from $0.9 million in 2004, as a result of the repayment of two credit lines in 2004 and a reduction of amounts outstanding on capital leases.

Net Income (Loss)

Our net loss was $9.6 million in 2005 compared to net income of $0.2 million in 2004, as a result of the factors described above.

Liquidity and Capital Resources

General

We require capital principally for working capital, debt service and capital expenditures. Working capital is required principally to finance accounts receivable and inventory. Our working capital requirements vary from period to period depending on manufacturing volumes, the timing of deliveries and the payment cycles of our customers. Our capital expenditures consist primarily of DIS cameras and vans, computer hardware and software. As of December 31, 2006, we had cash, cash equivalents and investments totaling $44.3 million. We currently invest our cash reserves in money market funds, high-grade auction rate securities and U.S. government or corporate debt securities. Based upon our current level of expenditures, we believe the proceeds from our initial public offering, together with cash flows from operating activities will be adequate to meet our anticipated cash requirements for working capital, debt service and capital expenditures for at least the next 12 months.

Net cash provided by operations totaled $0.2 million for 2006. We incurred a net loss of $6.3 million; however, $6.2 million of this amount represented non-cash charges including depreciation, amortization and stock-based compensation. The net cash provided by operations during the period resulted from a net reduction in working capital. Net cash used by investing activities amounted to $5.7 million in 2006, and includes $4.6 million of capital expenditures (primarily associated with our DIS operations) and $1.1 million of net purchases

of our securities available-for-sale. Net cash used by financing activities amounted to approximately $0.7 million in 2006, and primarily reflects the repayment of capital lease obligations, net of the proceeds arising from the exercise of stock options.

In December 2005, we announced a fleet upgrade program to replace the DIS fleet of mobile imaging systems over the next three years with our proprietary triple-head digital mobile gamma camera. We estimate that the remaining cost of this plan will be approximately $10 to $14 million through 2009, which we expect to fund from existing cash resources.

Debt Service

As of December 31, 2006, we had capital lease obligations totaling $0.4 million. These obligations are secured by the specific equipment financed under each lease and will be repaid monthly over the lease terms, which range from 3 to 26 months. Our DIS subsidiary entered into the majority of these capital lease obligations.

We are committed to making future cash payments on capital leases (including interest) and operating leases. We have not guaranteed the debt of any other party. The following table summarizes our contractual obligations as of December 31, 2006 (dollars in thousands):

	Payments Due by Period				
Contractual obligations	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Capital lease obligations	$ 392	$ 289	$ 103	$—	$ —
Operating lease obligations	2,966	1,169	1,656	141	—
Total	$3,358	$ 1,458	$1,759	$141	$ —

Critical Accounting Policies

The Securities and Exchange Commission defines critical accounting policies as those that are, in management's opinion, very important to the portrayal of our financial condition and results of operations and require our management's most difficult, subjective or complex judgments. In preparing our financial statements in accordance with generally accepted accounting principles in the United States, we must often make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses and related disclosures at the date of the financial statements and during the reporting period. Some of those judgments can be subjective and complex. Consequently, actual results could differ from our estimates. The accounting policies that are most subject to important estimates or assumptions include those described below.

Revenue Recognition

We derive revenue principally from providing in-office services to support the performance of nuclear imaging procedures and from selling and servicing solid-state digital gamma cameras. We recognize revenue in accordance with Staff Accounting Bulletin No. 104 when all of the following four criteria are met:

1. A contract or sales arrangement exists;

2. Products have been shipped and title has transferred or services have been rendered;

3. The price of the products or services is fixed or determinable; and

4. Collectibility is reasonably assured.

Our DIS revenue is recorded once the services and disposables are provided and consumed, which is normally on the day of the service. For our product revenue, these criteria are usually met upon delivery.

Reductions to our DIS revenue are recorded to provide for payment adjustments. Reductions to product revenue are recorded to provide for payment adjustments and credit memos and historically have not been significant.

Reserves for Doubtful Accounts and Billing Adjustments

Historically, the need to estimate reserves for accounts receivable has been limited to our DIS business. We provide reserves for billing adjustments and doubtful accounts. DIS payment adjustments and credit memos are adjustments for billing errors that are normally adjusted within the first 90 days subsequent to the performance of service, with the majority occurring within the first 30 days. Reserves are provided as a percentage of DIS revenue based on our historical experience rate. We use a combination of factors in evaluating the collectibility of accounts receivable. Each account is reviewed on at least a quarterly basis and a reserve percentage varying from zero to 100% for each account is established. We do not establish reserves for accounts with a history of payment without disputes.

We generally reserve a portion of the outstanding balance for accounts that are more than 180 days late and/or under dispute. We reserve 100% of the outstanding balance for accounts that we believe constitute a high risk of default based on factors such as level of dispute, payment history and our knowledge of a customer's inability to meet its obligations. We also consider our bad debt write-off history. Our estimates of collectibility could be impacted by material amounts by changed circumstances, such as a higher number of defaults or material adverse changes in a payor's ability to meet its obligations. The provision for billing adjustments is charged against DIS revenues and the provision for doubtful accounts is charged to general and administrative expenses. Our risk of material loss is mitigated as our average DIS customer balance is less than $20,000 and we generally do not have any single receivable in excess of $125,000.

Long-Lived Assets

We state property and equipment at cost. We capitalize betterments, which extend the useful life of the equipment. We calculate depreciation on property and equipment on the straight-line method over the estimated useful life (three to seven years for property and equipment) of the assets. We follow Financial Accounting Standards Board ("FASB") *Statement of Financial Accounting Standards ("SFAS") No. 144, Accounting for Impairment or Disposal of Long-Lived Assets*, which requires impairment losses to be recorded on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amount. If such assets are considered to be impaired, we measure the impairment recognized as the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. During the fourth quarter of 2005, we undertook an assessment of our DIS camera fleet to determine whether and when to deploy newer and more technically advanced models. Based on our assessment, we established a program to replace our existing camera fleet in its entirety over the next three years and we also concluded that we should reduce the depreciable life of our DIS cameras from seven to five years. Assets are examined for impairment annually or more frequently if events occur that may indicate potential asset impairment.

Inventory

We state inventories at the lower of cost (first-in, first-out) or market (net realizable value). Costs include material, labor and manufacturing overhead costs. We review our inventory balances quarterly for excess or obsolete inventory levels. Except where firm orders are on-hand, we consider production inventory quantities in excess of the next 12 months' demand as excess and reserve for them at 100% of cost, depending on our knowledge and forecast for the product. Service inventory in excess of 24 months demand is likewise reserved at 100% of cost. We establish obsolescence reserves at 100% for obsolete products. We review the reserve quarterly and, if necessary, make adjustments. We rely on historical information to support our reserve and utilize management's business judgment. Once the inventory is reserved, we do not adjust the reserve balance until the inventory is sold.

Warranty

We provide a warranty on certain of our products and accrue the estimated cost at the time revenue is recorded. Since July 2002, substantially all of the warranty periods have been 12 months before customer- sponsored maintenance begins. Warranty reserves are established based on historical experience with failure rates and repair costs and the number of systems at customers covered by warranty. We review warranty reserves quarterly and, if necessary, make adjustments.

Stock-based Compensation

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment", which is a revision of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" using the modified prospective method, which requires measurement of compensation of all stock based awards at fair value on the date of grant and recognition of compensation over the service period for awards expected to vest. Under this method, the provisions of SFAS 123(R) apply to all awards granted or modified after the date of adoption. In addition, the unrecognized expense of awards not yet vested at the date of adoption, determined under the original provisions of SFAS 123, shall be recognized in net income in the periods after adoption. The fair value of adoptions is determined using the Black-Scholes valuation model, which is consistent with valuation techniques previously utilized for options in footnote disclosures required under SFAS 123. Such value is recognized as expense over the service period, net of estimated forfeitures, using the straight-line method under SFAS 123(R).

Prior to the adoption of SFAS 123(R), we applied APB Opinion No. 25, "Accounting for Stock Issued to Employees" and related Interpretations, in accounting for our equity plans. Deferred compensation for stock options granted to employees was determined as the difference between the exercise price and the fair value of our common stock on the date of grant. Those amounts were initially recorded as a component of stockholders' equity and were amortized, on an accelerated basis, as a non-cash charge to cost of revenues and operations over the vesting period of the options.

Under SFAS 123(R), we calculated the fair value of stock option grants using the Black-Scholes-Merton option-pricing model. The weighted-average assumptions used in the Black-Scholes-Merton model for the year ended December 31, 2006 were 6.0 years for the expected term, 52.0% for the expected volatility, 4.8% for the risk free rate and 0% for dividend yield. Future expense amounts for any particular quarterly or annual period could be affected by changes in our assumptions or changes in market conditions. The weighted average expected option term for 2006 reflects the application of the simplified method set out in SEC Staff Accounting Bulletin No. 107 (SAB 107), which was issued in March 2005. The simplified method defines the life as the average of the contractual term of the options and the weighted average vesting period for all option tranches. Estimated volatility for fiscal 2006 also reflects the application of SAB 107 interpretive guidance and, accordingly, incorporates historical volatility of similar public entities.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Our exposure to market risk due to changes in interest rates relates primarily to the return on our investment portfolio. Our risk associated with fluctuating interest rates is limited to our investments in interest rate sensitive financial instruments. Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes. We attempt to increase the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in investment grade securities. A hypothetical 100 basis point adverse move in interest rates along the entire interest rate yield curve would not materially affect the fair value of our interest sensitive financial instruments due to their relatively short term nature. Declines in interest rates over time will, however, reduce our interest income while increases in interest rates over time will increase our interest income.

Item 8. Financial Statements and Supplementary Data

See the list of financial statements filed with this report under Item 15 below.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

Not applicable.

Item 9A. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Because of its inherent limitations, internal control over financial reporting may not prevent or detect all misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

We conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control—Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2006.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by Ernst & Young LLP, Independent Registered Public Accounting Firm. Their report which expressed an unqualified opinion on management's assessment of and on the effectiveness of our internal controls over financial reporting as of December 31, 2006 is included herein.

Report of Independent Registered Public Accounting Firm
on Internal Control Over Financial Reporting

The Board of Directors and Stockholders
Digirad Corporation

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Digirad Corporation maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Digirad Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, 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 or procedures may deteriorate.

In our opinion, management's assessment that Digirad Corporation maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Digirad Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Digirad Corporation as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006 of Digirad Corporation and our report dated February 16, 2007 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

San Diego, California
February 16, 2007

Item 9B. Other Information

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information required by this item will be set forth in the proxy statement and is incorporated in this report by reference.

Item 11. Executive Compensation

The information required by this item will be set forth in the Proxy Statement and is incorporated in this report by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this item will be set forth in the Proxy Statement and is incorporated in this report by reference.

Item 13. Certain Relationships and Related Transactions

The information required by this item will be set forth in the Proxy Statement and is incorporated in this report by reference.

Item 14. Principal Accounting Fees and Services

The information required by this item will be set forth in the Proxy Statement and is incorporated in this report by reference.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) Documents filed as part of this report.

1. The following financial statements of Digirad Corporation and Report of Ernst & Young LLP, independent registered public accounting firm, are included in this report:

2. Financial statement schedules.

SCHEDULE II—VALUATION AND QUALIFYING ACCOUNTS

	Reserve for bad debt (1)	Reserves for billing adjustments and contractual allowances (2)	Reserve for excess and obsolete inventories (3)
		(In thousands)	
Balance at December 31, 2003	$ 375	$ 258	$ 336
Provision	343	1,062	258
Write-offs and recoveries, net	(68)	(1,154)	(179)
Balance at December 31, 2004	650	166	415
Provision	766	1,086	605
Write-offs and recoveries, net	(534)	(1,035)	(124)
Balance at December 31, 2005	882	217	896
Provision	560	907	349
Write-offs and recoveries, net	(765)	(831)	(333)
Balance at December 31, 2006	$ 677	$ 293	$ 912

(1) The provision was charged against general and administrative expenses.
(2) The provision was charged against revenue.
(3) The provision was charged against cost of revenues.

No other financial statement schedules are provided because the information called for is not required or is shown either in the consolidated financial statements or the notes thereto.

3. List of exhibits required by Item 601 of Regulation S-K. See part (b) below.

(b) *Exhibits.* The following exhibits are filed as a part of this report:

Exhibit Number	Description
3.1(1)	Restated Certificate of Incorporation.
3.2(1)	Restated Bylaws.
4.1(2)	Form of Specimen Stock Certificate.
4.2(3)	Amended and Restated Investors' Rights Agreement by and among Digirad Corporation and the investors listed on the schedule attached thereto, dated April 23, 2002, as amended.
10.1(2)†	License Agreement by and between Digirad Corporation and the Regents of the University of California dated May 19, 1999, as amended.
10.2(1)†	Amendment to License Agreement by and between Digirad Corporation and the Regents of the University of California, dated July 26, 2004.
10.3(2)†	Software License Agreement by and between Digirad Corporation and Segami Corporation, dated June 16, 1999, as amended.
10.4(7)+	Addendum to Software License Agreement by and between Digirad Corporation and Segami Corporation, dated June 16, 1999, as amended.
10.5(2)†	License Agreement by and between Digirad Corporation and Cedars-Sinai Health System, dated May 22, 2001.
10.6(2)†	License Agreement by and between Digirad Corporation and Cedars-Sinai Health System, dated April 1, 2003.

Exhibit Number	Description
10.7(2)†	Development and Supply Agreement by and between Digirad Corporation and QuickSil, Inc., dated June 18, 1999.
10.8(2)	Loan and Security Agreement by and between Digirad Corporation and Silicon Valley Bank, dated July 31, 2001, as amended.
10.9(2)	Irrevocable Standby Letter of Credit executed by Silicon Valley Bank in favor of Digirad Corporation, dated November 5, 2003.
10.10(2)	Loan Agreement by and between Digirad Corporation and Gerald G. Loehr Trust, dated September 1, 1993, as amended.
10.11(4)	Amendment to Loan Agreement dated effective August 9, 2004, by and between Digirad Corporation and the Gerald G. Loehr Separate Property Trust.
10.12(2)	Loan Agreement by and between Digirad Corporation and Clinton L. Lingren, dated September 1, 1993, as amended.
10.13(2)	Loan Agreement by and between Digirad Corporation and Jack F. Butler, dated September 1, 1993, as amended.
10.14(2)	Equipment Lease Agreement by and between Orion Imaging Systems, Inc. and MarCap Corporation, dated October 1, 2000.
10.15(2)	Equipment Lease Agreement by and between Digirad Imaging Solutions, Inc. and MarCap Corporation, dated June 13, 2003.
10.16(2)	Master Equipment Lease Agreement by and between Digirad Imaging Solutions, Inc. and DVI Financial Services, Inc., dated May 24, 2001.
10.17(2)	Sublease Agreement by and between Digirad Corporation as sub-lessee and REMEC, Inc. as sub-lessor, dated November 3, 2003.
10.18(2)#	1991 Stock Option Program Stock Option Agreement.
10.19(2)#	1997 Stock Option/Stock Issuance Plan, as amended.
10.20(7)#	1998 Stock Option/Stock Issuance Plan, as amended.
10.21(1)#	2004 Stock Incentive Plan.
10.22(7)#	Form of Notice of Stock Option Award and Stock Option Award Agreement for 2004 Stock Incentive Plan.
10.23(2)#	2004 Non-Employee Director Option Program.
10.24(7)#	Form of Notice of Stock Option Award and Stock Option Award Agreement for 2004 Non-Employee Director Option Program.
10.25(2)#	Form of Indemnification Agreement.
10.26(2)#	Letter Agreement by and between Digirad Corporation and David M. Sheehan, dated June 11, 2002.
10.27(2)	Loan and Security Agreement by and between Orion Imaging Systems, Inc., Digirad Imaging Systems, Inc. and Heller Healthcare Finance, Inc., dated January 9, 2001, as amended.
10.28(2)	Master Lease Agreement by and between Digirad Corporation and GE Healthcare Financial Services, dated September 26, 2000.
10.29+	Agreement for Services between our wholly-owned subsidiary, Digirad Imaging Solutions, Inc. (“DIS”) and MBR and Associates, Inc., (“MBR”) dated December 27, 2006 (the “Agreement for Services”).

Exhibit Number	Description
10.30(2)	Form of Warrant to purchase shares of Series E Preferred Stock by and among Digirad Corporation and the investors listed on the schedule attached thereto.
10.31(2)	Form of Warrant to purchase shares of Series E Preferred Stock by and among Digirad Corporation and the investors listed on the schedule attached thereto.
10.32(2)	Form of Warrant to purchase shares of Common Stock by and among Digirad Corporation and the investors listed on the schedule attached thereto.
10.33(2)	Warrant to purchase shares of Series E Preferred Stock by and between Digirad Corporation and Silicon Valley Bank, dated July 31, 2001.
10.34(2)	Form of Warrant to purchase shares of Common Stock by and among Digirad Corporation and the investors listed on the schedule attached thereto.
10.35(2)	Form of Warrant to purchase shares of Common Stock by and among Digirad Corporation and the investors listed on the schedule attached thereto.
10.36(2)	Form of Warrant to purchase shares of Common Stock by and between Digirad Corporation and the investors listed on the schedule attached thereto.
10.37(1)	Form of Warrant to purchase shares of Common Stock by and between Digirad Corporation and the investors listed on the schedule attached thereto.
10.38(3)	Form of Warrant to purchase shares of Common Stock by and between Digirad Corporation and the investors listed on the schedule attached thereto.
10.39(5)	2005 Inducement Stock Incentive Plan.
10.40(5)	2005 Inducement Stock Incentive Plan Award Agreement.
10.41#(6)	Executive Employment Agreement by and between Digirad Corporation and Mark Casner, dated September 14, 2005.
10.42+(7)	Supply Agreement by and between Digirad Corporation and QuickSil, Inc., dated October 31, 2005.
10.43#(7)	Amendment to Executive Employment Agreement by and between Digirad Corporation and Mark Casner, dated January 15, 2006.
10.44#(7)	Second Amendment to Executive Employment Agreement by and between Digirad Corporation and Mark Casner, dated March 3, 2006.
10.45#(8)	Third Amendment to Executive Employment Agreement by and between Digirad Corporation and Mark Casner, dated December 13, 2006.
21.1(2)	Subsidiaries of Digirad Corporation.
23.1	Consent of Independent Registered Public Accounting Firm.
31.1	Certification of Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated pursuant to the Securities Exchange Act of 1934, as amended.
31.2	Certification of Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated pursuant to the Securities Exchange Act of 1934, as amended.
32.1(9)	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2(9)	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) This exhibit was previously filed as an exhibit to the Company's quarterly report on Form 10-Q originally filed with the Commission on August 11, 2004, as amended thereafter, and is incorporated herein by reference.

(2) This exhibit was previously filed as an exhibit to the Registration Statement on Form S-1 (File No. 333-113760) originally filed with the Securities and Exchange Commission on March 19, 2004, as amended thereafter, and is incorporated herein by reference.
(3) This exhibit was previously filed as an exhibit to the Company's quarterly report on Form 10-Q filed with the Commission on November 2, 2004, and is incorporated herein by reference.
(4) This exhibit was previously filed as an exhibit to the Company's current report on Form 8-K filed with the Commission on September 7, 2004, and is incorporated herein by reference.
(5) This exhibit was previously filed as an exhibit to the Company's current report on Form 8-K filed with the Commission on September 15, 2005, and is incorporated herein by reference.
(6) The exhibit was previously filed as an exhibit to the Company's quarterly report on Form 10-Q filed with the Commission on November 4, 2005, and is incorporated herein by reference.
(7) This exhibit was previously filed as an exhibit to the Company's annual report on Form 10-K filed with the Commission on March 3, 2005, and is incorporated herein by reference.
(8) This exhibit was previously filed as an exhibit to the Company's current report on Form 8-K filed with the Commission on December 14, 2006, and is incorporated herein by reference.
(9) The certifications attached as Exhibits 32.1 and 32.2 that accompany this Annual Report on Form 10-K, are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of Digirad Corporation under the Securities Exchange Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Form 10-K, irrespective of any general incorporation language contained in such filing.
† Digirad Corporation has been granted confidential treatment with respect to certain portions of this exhibit (indicated by asterisks), which have been filed separately with the Commission.
+ Portions of this exhibit (indicated by asterisks) have been omitted pursuant to a request for confidential treatment and have been separately filed with the Commission.
# Indicates management contract or compensatory plan.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

DIGIRAD CORPORATION

Dated: February 16, 2007

By: /s/ MARK L. CASNER
Name: **Mark L. Casner**
Title: ***President and Chief Executive Officer***

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

Name	Title	Date
/s/ MARK L. CASNER **Mark L. Casner**	President, Chief Executive Officer and Director *(Principal Executive Officer)*	February 16, 2007
/s/ TODD P. CLYDE **Todd P. Clyde**	Chief Financial Officer *(Principal Financial and Accounting Officer)*	February 16, 2007
/s/ TIMOTHY J. WOLLAEGER **Timothy J. Wollaeger**	Director *(Chairman of the Board of Directors)*	February 16, 2007
/s/ GARY F. BURBACH **Gary F. Burbach**	Director	February 16, 2007
/s/ RAYMOND V. DITTAMORE **Raymond V. Dittamore**	Director	February 16, 2007
/s/ R. KING NELSON **R. King Nelson**	Director	February 16, 2007
/s/ KENNETH E. OLSON **Kenneth E. Olson**	Director	February 16, 2007
/s/ DOUGLAS REED, M.D. **Douglas Reed, M.D.**	Director	February 16, 2007

DIGIRAD CORPORATION

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of Digirad Corporation

We have audited the accompanying consolidated balance sheets of Digirad Corporation as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. Our audits also include the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Digirad Corporation at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with generally accepted accounting principles in the United States. Also, in our opinion, the financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, in 2006 the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 123 (R), "Share Based Payment".

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Digirad Corporation's internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 16, 2007 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

San Diego, California
February 16, 2007

Digirad Corporation

Consolidated Balance Sheets
(In thousands, except par value amounts)

	As of December 31, 2006	2005
Assets		
Current assets:		
Cash and cash equivalents	$ 10,070	$ 16,303
Securities available-for-sale	34,256	33,202
Accounts receivable, net	7,534	8,132
Inventories, net	5,860	5,136
Other current assets	1,499	1,687
Total current assets	59,219	64,460
Property and equipment, net	9,570	9,582
Intangibles, net	428	402
Restricted cash	60	60
Total assets	$ 69,277	$ 74,504
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 2,643	$ 2,152
Accrued compensation	3,650	2,585
Accrued warranty	788	825
Other accrued liabilities	3,306	4,614
Deferred revenue	2,775	2,858
Current portion of long-term debt	269	766
Total current liabilities	13,431	13,800
Long-term debt, net of current portion	99	368
Deferred rent	302	348
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.0001 par value: 10,000 shares authorized at December 31, 2006 and 2005, respectively; no shares issued and outstanding at December 31, 2006 and 2005	—	—
Common stock, $0.0001 par value: 150,000 shares authorized at December 31, 2006 and 2005; 18,795 and 18,705 shares issued and outstanding at December 31, 2006 and 2005, respectively	2	2
Additional paid-in capital	151,539	150,201
Accumulated other comprehensive loss	(91)	(221)
Deferred compensation	—	(279)
Accumulated deficit	(96,005)	(89,715)
Total stockholders' equity	55,445	59,988
Total liabilities and stockholders' equity	$ 69,277	$ 74,504

See accompanying notes.

Digirad Corporation

Consolidated Statements of Operations
(In thousands, except per share amounts)

	Years ended December 31,		
	2006	2005	2004
Revenues:			
DIS	$49,614	$ 50,194	$44,505
Product	22,312	17,992	23,632
Total revenues	71,926	68,186	68,137
Cost of revenues:			
DIS	37,675	37,376	31,221
Product	15,192	15,564	15,157
Total cost of revenues	52,867	52,940	46,378
Gross profit	19,059	15,246	21,759
Operating expenses:			
Research and development	3,894	3,747	3,115
Sales and marketing	8,827	7,420	7,762
General and administrative	14,535	14,903	10,236
Amortization and impairment of intangible assets	27	179	64
Total operating expenses	27,283	26,249	21,177
Income (loss) from operations	(8,224)	(11,003)	582
Other income (expense):			
Interest income	2,100	1,678	576
Interest expense	(112)	(217)	(888)
Other expense	(54)	(77)	(25)
Total other income (expense)	1,934	1,384	(337)
Net income (loss)	(6,290)	(9,619)	245
Accretion of deferred issuance costs on preferred stock	—	—	(161)
Net income (loss) applicable to common stockholders	$ (6,290)	$ (9,619)	$ 84
Basic and diluted net income (loss) per share (1)	$ (0.34)	$ (0.52)	$ 0.01
Shares used in per share computations:			
Basic (1)	18,761	18,468	10,095
Diluted (1)	18,761	18,468	16,963

(1) As a result of the conversion of our preferred stock into 12.4 million shares of our common stock upon completion of our initial public offering in June 2004, there is a lack of comparability in the basic and diluted net income (loss) per share amounts for the periods presented above. Please refer to Note 1 for the pro forma basic and diluted net income (loss) per share calculations for the periods presented.

See accompanying notes.

Digirad Corporation

Consolidated Statements of Changes in Stockholders' Equity
(In thousands)

	Common stock		Additional paid-in capital	Accumulated other comprehensive loss	Deferred Compensation	Accumulated deficit	Total stockholders' equity (deficit)
	Shares	Amount					
Balance at December 31, 2003	24	$ —	$ 5,032	$ —	$ (555)	$ (80,180)	$ (75,703)
Exercise of common stock options and warrants	107	—	51	—	—	—	51
Deferred compensation	—	—	1,471	—	(1,471)	—	—
Amortization of deferred compensation	—	—	—	—	1,106	—	1,106
Issuance of warrants to consultants	—	—	40	—	—	—	40
Issuance of common stock in initial public offering	5,500	1	58,813	—	—	—	58,814
Conversion of preferred stock into common stock	12,444	1	84,438	—	—	—	84,439
Accretion of deferred issuance costs on preferred stock	—	—	—	—	—	(161)	(161)
Comprehensive income:							
Net income	—	—	—	—	—	245	245
Unrealized loss on securities available-for-sale	—	—	—	(97)	—	—	(97)
Total comprehensive income	—	—	—	—	—	—	148
Balance at December 31, 2004	18,075	2	149,845	(97)	(920)	(80,096)	68,734
Exercise of common stock options	630	—	345	—	—	—	345
Issuance costs related to initial public offering settled for less than the amount provided	—	—	155	—	—	—	155
Deferred compensation	—	—	(144)	—	144	—	—
Amortization of deferred compensation	—	—	—	—	497	—	497
Comprehensive loss:							
Net loss	—	—	—	—	—	(9,619)	(9,619)
Unrealized loss on securities available-for-sale	—	—	—	(124)	—	—	(124)
Total comprehensive loss	—	—	—	—	—	—	(9,743)
Balance at December 31, 2005	18,705	2	150,201	(221)	(279)	(89,715)	59,988
Elimination of deferred compensation upon adoption of FAS 123(R)	—	—	(279)	—	279	—	—
Stock-based compensation	—	—	1,574	—	—	—	1,574
Exercise of common stock options	90	—	43	—	—	—	43
Comprehensive loss:							
Net loss	—	—	—	—	—	(6,290)	(6,290)
Unrealized gain on securities available-for-sale	—	—	—	130	—	—	130
Total comprehensive loss	—	—	—	—	—	—	(6,160)
Balance at December 31, 2006	18,795	$ 2	$ 151,539	$ (91)	$ —	$ (96,005)	$ 55,445

See accompanying notes.

Digirad Corporation

Consolidated Statements of Cash Flows
(In thousands)

	Years ended December 31,		
	2006	2005	2004
Operating activities			
Net income (loss)	$ (6,290)	$ (9,619)	$ 245
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation	4,522	4,602	3,086
Loss on disposal of assets	82	78	29
Amortization and impairment of intangible assets	68	216	64
Stock-based compensation	1,574	497	1,106
Options, warrants and other equity instruments issued to non-employees	—	—	11
Amortization of premium on securities available-for-sale	133	446	134
Changes in operating assets and liabilities:			
Accounts receivable	598	1,885	2,178
Inventories	(724)	1,844	(3,271)
Other assets	188	(67)	(737)
Accounts payable	491	(2,161)	1,277
Accrued compensation	1,065	175	517
Accrued warranty and other accrued liabilities	(1,391)	1,701	542
Deferred revenue	(83)	514	830
Net cash provided by operating activities	233	111	6,011
Investing activities			
Purchases of securities available-for-sale	(19,507)	(30,032)	(77,969)
Maturities of securities available-for-sale	18,450	40,475	33,523
Purchases of property and equipment	(4,592)	(3,079)	(4,210)
Other assets	(94)	(17)	(94)
Net cash provided (used) by investing activities	(5,743)	7,347	(48,750)
Financing activities			
Net issuances of common stock	43	345	58,865
Net payments under lines of credit	—	—	(9,356)
Proceeds from capital lease financing	—	—	312
Repayment of obligations under capital leases	(766)	(2,848)	(2,680)
Repayment of notes receivable from stockholders	—	—	(735)
Net cash provided (used) by financing activities	(723)	(2,503)	46,406
Net increase (decrease) in cash and cash equivalents	(6,233)	4,955	3,667
Cash and cash equivalents at beginning of year	16,303	11,348	7,681
Cash and cash equivalents at end of year	$ 10,070	$ 16,303	$ 11,348
Supplemental information:			
Cash paid during the period for interest	$ 79	$ 175	$ 894
Conversion of preferred stock to common stock	$ —	$ —	$ 84,439

See accompanying notes.

Digirad Corporation

Notes to Consolidated Financial Statements

1. Organization and Summary of Significant Accounting Policies

Organization and Business

Digirad Corporation ("Digirad"), a Delaware corporation, is a leading provider of cardiovascular imaging services and solid-state nuclear medicine imaging products to physician offices, hospitals, and imaging centers. Our Digirad Imaging Solutions, Inc. subsidiary ("DIS") provides in-office services to physicians, offering certified personnel, required licensure, an imaging system and other support for the performance of nuclear imaging procedures under the supervision of our physician customers. DIS customers enter into annual lease contracts for imaging services delivered on a per-day basis.

Basis of Presentation

The accompanying consolidated financial statements include the operations of DIS. Inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and disclosures made in the accompanying notes to the consolidated financial statements. Our significant estimates include the reserve for doubtful accounts, revenue adjustments, excess and obsolete inventories, warranty costs and the valuation allowance for deferred tax assets. Actual results could differ from those estimates.

Revenue Recognition

We have two primary sources of revenue: 1) product sales and 2) mobile in-office nuclear imaging services. We recognize revenue when all four of the following criteria are met: (i) persuasive evidence that an arrangement exists; (ii) delivery of the products and/or services has occurred; (iii) the selling price is fixed or determinable; and (iv) collectibility is reasonably assured. In addition, we comply with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* ("SAB 104"). SAB 104 sets forth guidelines on the timing of revenue recognition based upon factors such as passage of title, installation, payment terms and customer acceptance.

Product revenues consist of revenues from the sales of gamma cameras and follow on maintenance services and we generally recognize revenue upon delivery to customers. We also provide installation and training for camera sales in the United States. Installation and training is generally performed shortly after delivery and represents an insignificant cost, which we accrue at the time revenue is recognized. Neither service is essential to the functionality of the product. We also sell or provide maintenance services beyond the first year following the purchase by the customer. Revenue from these contracts is deferred and recognized ratably over the period of the obligation and is included in product sales in the accompanying consolidated statements of operations.

DIS revenue is derived from our mobile in-office nuclear imaging services. Revenue related to mobile imaging services is recognized at the time services are performed and disposables are provided and collection is reasonably assured. No product sales are included in DIS revenue. DIS services are generally billed on a per-day basis under annual contracts which specify the number of days of service to be provided. If a physician fails to complete a minimum number of lease days in a given annual period, we have the right to bill the physician for the shortfall, although we generally recognize such revenue upon collection. We are compensated for mobile imaging services provided to patients directly from the physicians under contract.

Cash and Cash Equivalents

We consider all investments with an original maturity of three months or less to be cash equivalents. Cash equivalents primarily represent funds invested in money market funds whose cost equals fair market value.

Digirad Corporation

Notes to Consolidated Financial Statements—(Continued)

Securities, Available-for-Sale

Securities consist of high-grade auction rate securities, U.S. government and corporate debt securities. We classify all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income (loss) in stockholder's equity until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis. A decline in the market value of any available-for-sale security below cost that is determined to be other than temporary results in a revaluation of its carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. No such impairment charges were recorded for any period presented. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the straight-line method. Interest income is recognized when earned. Realized gains and losses on investments in securities have not been material for any period presented. The amortization and accretion, interest income and realized gains and losses are included in interest income within the Consolidated Statements of Operations. The composition of investments at December 31, 2006 and 2005 are as follows (in thousands):

As of December 31, 2006	Maturity in Years	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Auction rate securities	1 or less	$ 11,000	$—	$ —	$ 11,000
Corporate debt securities	1 to 3	12,707	—	(43)	12,664
U.S. government securities	1 to 3	10,640	—	(48)	10,592
		$ 34,347	$—	$ (91)	$ 34,256

As of December 31, 2005	Maturity in Years	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Auction rate securities	1 or less	$ 7,200	$—	$ —	$ 7,200
Corporate debt securities	1 to 3	10,994	—	(185)	10,809
U.S. government securities	1 to 3	15,229	—	(36)	15,193
		$ 33,423	$—	$(221)	$ 33,202

Concentration of Credit Risk

We invest our cash in accordance with guidelines which require our investments in marketable securities to meet minimum credit ratings assigned by established credit organizations. We also diversify our investments through specifying maximum investments by instrument type and issuer. It is our policy to invest in instruments that have a final maturity of no longer than three years, with a portfolio weighted average maturity of no longer than 18 months.

We have primarily sold our products to customers in the United States and its possessions. We have had limited sales internationally. For the years ended December 31, 2006, 2005 and 2004, no product customer or DIS customer accounted for 10% or more of consolidated revenues.

We maintain reserves for potential credit losses and billing adjustments. We provide a reserve for potential credit losses for accounts which we believe pose a high risk of default based on a combination of factors such as length of time the receivables are past due and customer payment history, as well as our historical bad debt write-off experience. Our estimates of collectibility could be impacted materially by changed circumstances,

such as a higher number of defaults or material adverse changes in a payor's ability to meet its obligations. Billing adjustments are adjustments for billing errors that are normally adjusted within the first 90 days subsequent to the performance of service, with the majority occurring within the first 30 days. Reserves are provided as a percentage of DIS revenue based on our historical experience rate.

Fair-value of Financial Instruments

The carrying value of financial instruments, such as cash and cash equivalents, securities available-for-sale, accounts receivable, accounts payable and accrued liabilities approximate their fair value because of their short term nature. We do not hold or issue financial instruments for trading purposes.

Inventories

Inventories consist of raw materials, work in process and finished goods and are stated at the lower of cost or market, cost being determined on a first-in, first-out basis. We establish reserves for estimated excess or obsolete inventories based upon assumptions about future demand for our products.

Property and Equipment

Property and equipment are carried at cost, net of depreciation. Depreciation and amortization of property and equipment, including assets recorded under capital leases, are provided using the straight-line method over the shorter of the estimated useful lives of the related assets, which is three to seven years, or the lease term, if applicable.

Intangibles

Intangibles include patents, trademarks and acquired customer contracts and are recorded at cost. Patents are amortized over the lesser of their estimated useful or legal lives (up to 20 years). Trademarks are amortized over 10 years. Annual amortization expense related to our intangibles is estimated to be approximately $25,000 in each of the next 5 fiscal years.

Impairment of Long-Lived Assets

We follow Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The scope of SFAS No. 144 includes long-lived assets, or groups of assets, to be held and used as well as those which are to be disposed of by sale or by other method, but excludes a number of long-lived assets such as goodwill and intangible assets not being amortized under the application of SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 144 requires impairment losses to be recorded on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amount. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. We perform an annual review of the carrying value of our long-lived assets to be held and used, including certain identifiable intangible assets, during the fourth quarter of each fiscal year. No material impairment charges were recorded during 2006, 2005 or 2004 related to identifiable intangible assets.

Shipping and Handling Fees and Costs

We record all shipping and handling billings to a customer in a sales transaction as revenue earned for the goods provided in accordance with the Emerging Issues Task Force ("EITF") Issue 00-10, *Accounting for*

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Notes to Consolidated Financial Statements—(Continued)

Shipping and Handling Fees and Costs. Our revenues related to shipping and handling for all periods presented are immaterial. Shipping and handling costs are included in cost of revenues and were $0.3 million, $0.3 million and $0.4 million for 2006, 2005 and 2004, respectively.

Stock-based Compensation

Adoption of SFAS 123(R)

Effective January 1, 2006, we adopted the fair value recognition provisions of the Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), *Share-Based Payment* ("SFAS 123(R)"). Stock-based compensation expenses which were presented as a separate line item on the consolidated statement of operations in the prior periods have been reclassified to conform to the current year's presentation. In accordance with SFAS 123(R), we utilized the prospective method for equity share options granted prior to our initial public offering as we had used the minimum value method of measuring these options for the pro forma disclosures. We utilized the modified prospective method for equity share options granted subsequent to our initial public offering as we had used the fair-value-based method for pro forma disclosure purposes under SFAS No. 123, *Accounting for Stock-Based Compensation* ("SFAS 123"). Under these transition methods, compensation cost recognized in fiscal 2006 includes the following: (a) share-based compensation cost associated with options granted prior to our initial public offering with exercise prices less than the deemed fair value of the common stock at the date of grant, based on the minimum value pricing model allowed under Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations ("APB 25"), (b) compensation cost related to any share-based payments granted subsequent to the date of our initial public offering through, but not vested as of, December 31, 2005, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and (c) compensation cost for any share-based payments granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R).

Prior to the completion of our initial public offering in June 2004, stock options were granted at exercise prices that were below the deemed fair value of the common stock on the date of grant. Accordingly, deferred stock compensation was recorded in accordance with APB 25. The deferred stock compensation was amortized on an accelerated basis over the vesting period of the related awards. In accordance with SFAS 123(R), we reversed the balance of deferred compensation from stockholders' equity on the date of adoption but, as noted above, we continue to recognize the related compensation cost in the statements of operations.

As a result of adopting SFAS 123(R), our net loss for the year ended December 31, 2006 is approximately $1.4 million greater than if we had continued to account for share-based compensation under APB 25. As a result of adopting SFAS 123(R), basic and diluted loss per share for the year ended December 31, 2006, was reduced by $0.07 per share.

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Notes to Consolidated Financial Statements—(Continued)

Compensation Costs

Results of operations for the years ended December 31, 2006, 2005 and 2004 include stock-based compensation costs of $1.6 million, $0.5 million, and $1.1 million, respectively. Share-based compensation capitalized as part of our inventory was not significant in either period. There were no significant modifications to our share-based employee payment plans during the periods presented that resulted in any incremental compensation cost. Following is a summary of stock-based compensation costs, by income statement classification:

	Years ended December 31,		
	2006	2005	2004
The composition of stock-based compensation is as follows:			
Cost of DIS revenue	$ 141	$103	$ 216
Cost of product revenue	74	53	165
Research and development	130	67	133
Sales and marketing	279	46	136
General and administrative	942	228	467
	$1,566	$497	$1,117

Valuation of Stock Option Awards

The fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton option pricing formula that uses the assumptions noted in the following table. All options granted have a maximum term of ten years. As permitted by Staff Accounting Bulletin No. 107, *Share-Based Payment* ("SAB 107"), we utilized the "shortcut approach" to estimate the options' expected term, which represents the period of time that options granted are expected to be outstanding. We utilized this approach as our historical share option exercise experience does not provide a reasonable basis upon which to estimate an expected term. Expected volatilities are based on historical volatility of our stock as well as the stock of comparable companies. We estimated the forfeiture rate based on historical data for forfeitures and we are recognizing compensation costs only for those equity awards expected to vest. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield in effect at the time of grant. We have never declared or paid dividends and have no plans to do so in the foreseeable future.

The following weighted-average assumptions were utilized for the calculations during each period:

	Years ended December 31,		
	2006	2005	2004
Expected life (in years)	6.02	5.00	5.00
Weighted average volatility	51-55%	73%	43%
Forfeiture rate	18%	—	—
Risk-free interest rate	4.52–5.07%	4.02%	3.32%
Expected dividend yield	—	—	—

Adjusted net loss information

Prior to adoption of SFAS 123(R), we followed APB 25 in accounting for our employee stock options as permitted by SFAS 123. The following table illustrates the effect on net loss and loss per share as if we had

applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation for the years ended December 31, 2005 and 2004, prior to the adoption of SFAS 123(R). For purposes of this pro forma disclosure, the fair value of the options granted prior to the completion of our initial public offering was estimated at the date of grant using the minimum value pricing model. Upon completion of the initial public offering in June 2004, we began using the Black-Scholes model to estimate fair value. The estimated fair value of the options is amortized on an accelerated basis in accordance with Financial Accounting Standards Board Interpretation ("FIN") No. 28 over the vesting period. Disclosures for the year ended December 31, 2006 are not presented in the following table because stock-based payments were accounted for under SFAS 123(R)'s fair-value method during those periods.

Our adjusted net loss information for the years ended December 31, 2005 and 2004 are as follows (in thousands):

	Years ended December 31,	
	2005	2004
Net income (loss) applicable to common stockholders, as reported	$ (9,619)	$ 84
Add: total stock-based employee compensation included in reported net loss	497	1,106
Less: total stock-based employee compensation determined under the fair value method for all awards	(3,977)	(2,104)
Adjusted net loss	(13,099)	(914)
Basic and diluted net income (loss) per share, as reported	$ (0.52)	$ 0.01
Adjusted basic and diluted net loss per share	$ (0.71)	$ (0.09)

Warranty

We provide a warranty on certain of our products and accrue the estimated cost at the time revenue is recorded. Warranty expense is charged to product cost of revenues. The majority of all warranty periods are 12 months before customer-sponsored maintenance begins. Warranty reserves are established based on historical experience with failure rates and repair costs and the number of gamma cameras covered by warranty. Warranty reserves are depleted as gamma cameras are repaired. The costs consist principally of materials, personnel, overhead and transportation. We review warranty reserves quarterly and, if necessary, make adjustments. The activities in our warranty reserve are as follows (in thousands):

	Years ended December 31,		
	2006	2005	2004
Balance at beginning of year	$ 825	$ 1,219	$ 1,051
Charges to cost of revenues	963	1,160	1,670
Applied to liability	(1,000)	(1,554)	(1,502)
Balance at end of year	$ 788	$ 825	$ 1,219

Research and Development

Research and development costs are expensed as incurred.

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Notes to Consolidated Financial Statements—(Continued)

Advertising Costs

Advertising costs are expensed as incurred. Total advertising costs for the years ended December 31, 2006, 2005 and 2004 (in thousands), were $0.7 million, $0.5 million and $0.5 million, respectively.

Net Income (Loss) Per Share

We calculate net income (loss) per share in accordance with SFAS No. 128, *Earnings Per Share*. Basic earnings per share ("EPS") is calculated by dividing the net income or loss available to common stockholders by the weighted average number of common shares outstanding for the period, without consideration for common stock equivalents. Diluted EPS is computed by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period and the weighted average number of dilutive common stock equivalents outstanding for the period determined using the treasury-stock method. For purposes of this calculation, common stock subject to repurchase by us, convertible preferred stock, options, and warrants are considered to be common stock equivalents and are only included in the calculation of diluted earnings per share when their effect is dilutive.

Upon the completion of our initial public offering in June 2004, all of our previously outstanding preferred shares converted into 12.4 million shares of our common stock. As a result of the issuance of these common shares, there is a lack of comparability in both the basic and diluted net income (loss) per share amounts for the periods presented. In order to provide a more relevant measure of our operating results, an unaudited pro forma net income (loss) per share calculation has been included. The shares used to compute unaudited pro forma basic and diluted net income (loss) per share include the assumed conversion of all outstanding shares of preferred stock into shares of common stock using the as-if converted method as of the beginning of each period presented or the date of issuance, if later.

Digirad Corporation

Notes to Consolidated Financial Statements—(Continued)

Historical and pro forma basic and diluted net income (loss) per share were calculated as follows (in thousands, except per share amounts):

	Years ended December 31,		
	2006	2005	2004
Historical:			
Numerator:			
Net income (loss)—diluted	$ (6,290)	$ (9,619)	$ 245
Accretion of deferred issuance costs on preferred stock	—	—	(161)
Net income (loss) applicable to common stockholders—basic	$ (6,290)	$ (9,619)	$ 84
Denominator:			
Weighted average common shares outstanding—basic	18,761	18,468	10,095
Effect of dilutive securities:			
Conversion of preferred stock	—	—	5,489
Options	—	—	1,353
Warrants	—	—	26
Weighted average common shares outstanding—diluted	18,761	18,468	16,963
Net income (loss) per common share applicable to common shareholders:			
Basic	$ (0.34)	$ (0.52)	$ 0.01
Diluted	$ (0.34)	$ (0.52)	$ 0.01
Pro forma:			
Numerator:			
Net income (loss)—basic and diluted	$ (6,290)	$ (9,619)	$ 245
Denominator:			
Weighted average common shares outstanding—basic	18,761	18,468	10,095
Pro forma adjustments to reflect weighted average effect of assumed conversion of preferred stock	—	—	5,489
Pro forma weighted average common shares outstanding—basic	18,761	18,468	15,584
Weighted average common shares outstanding—diluted	18,761	18,468	10,095
Pro forma adjustments to reflect weighted average effect of assumed conversion of preferred stock	—	—	5,489
Effect of dilutive securities:			
Options	—	—	1,353
Warrants	—	—	26
Pro forma weighted average common shares outstanding—diluted	18,761	18,468	16,963
Pro forma net income (loss) per common share:			
Basic	$ (0.34)	$ (0.52)	$ 0.02
Diluted	$ (0.34)	$ (0.52)	$ 0.01

Potentially dilutive securities (in thousands) totaling 412 and 749 at December 31, 2006 and 2005, respectively, were excluded from historical basic and diluted earnings per share because of their anti-dilutive effect.

Digirad Corporation

Notes to Consolidated Financial Statements—(Continued)

Recently Issued Accounting Standards

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* that will become effective beginning first quarter of 2008. This statement defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements. However, for some entities, the application of this statement will change current practice. The Company believes the adoption of this standard will have no material effect on its financial position, results of operations or cash flows.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements* ("SAB 108") to address diversity in practice in quantifying financial statement misstatements and the potential under current practice for the build up of improper amounts on the balance sheet. SAB 108 will become effective beginning in the fourth quarter of 2006. The Company believes the adoption of this standard will have no material effect on its financial position, results of operations or cash flows.

In July 2006, the FASB released FASB Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*" ("FIN 48"). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company will adopt this Interpretation in the first quarter of 2007. The cumulative effects, if any, of applying this Interpretation will be recorded as an adjustment to retained earnings as of the beginning of the period of adoption. The Company is currently in the process of evaluating the expected effect of FIN 48 on its consolidated financial statements and is currently not yet in a position to determine such effects.

In April 2006, the FASB issued FASB Staff Position (FSP) FIN 46(R)-6, "*Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*" ("FSP FIN 46(R)-6"), that became effective beginning third quarter of 2006. FSP FIN No. 46(R)-6 clarifies that the variability to be considered in applying FASB Interpretation 46(R) shall be based on an analysis of the design of the variable interest entity. The Company adopted the provisions of FSP FIN 46(R)-6 in the third quarter of 2006. The adoption of FSP FIN 46(R)-6 did not have a material impact on the Company's financial position, results of operations or cash flows.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, "*Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*" ("SFAS 154"). This statement applies to all voluntary changes in accounting principle and changes required by an accounting pronouncement where no specific transition provisions are included. SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. Retrospective application is limited to the direct effects of the change; the indirect effects should be recognized in the period of the change. The Company adopted the provisions of SFAS 154 in the first quarter of 2006. The adoption of SFAS 154 did not have a material impact on the Company's financial position, results of operations or cash flows.

Digirad Corporation

Notes to Consolidated Financial Statements—(Continued)

2. Financial Statement Details

The composition of certain balance sheet accounts is as follows (in thousands):

Accounts Receivable

	December 31,	
	2006	2005
Accounts receivable	$ 8,504	$ 9,231
Less reserves and allowance for doubtful accounts	(970)	(1,099)
	$ 7,534	$ 8,132

Inventories

	December 31,	
	2006	2005
Raw materials	$ 2,985	$ 2,087
Work-in-progress	3,316	3,431
Finished goods	471	514
	6,772	6,032
Less reserves for excess and obsolete inventories	(912)	(896)
	$ 5,860	$ 5,136

Property and Equipment

	December 31,	
	2006	2005
Machinery and equipment	$ 21,276	$ 20,388
Furniture and fixtures	158	230
Computers and software	3,446	3,309
Leasehold improvements	749	742
	25,629	24,669
Less accumulated depreciation and amortization	(16,059)	(15,087)
	$ 9,570	$ 9,582

Digirad Corporation

Notes to Consolidated Financial Statements—(Continued)

Other Accrued Liabilities

	December 31, 2006	December 31, 2005
Radiopharmaceuticals and consumable medical supplies	$ 579	$1,101
Professional fees	495	644
Outside services and consulting	454	301
Customer deposits	355	1,073
Facilities and related costs	279	102
Travel expenses	244	313
Sales and property taxes payable	236	217
Other accrued liabilities	664	863
	$3,306	$4,614

3. Debt

In thousands

	December 31, 2006	December 31, 2005
Total debt	$ 368	$1,134
Current portion of debt	(269)	(766)
Long-term debt, less current portion	$ 99	$ 368

During 2000 through 2004, we entered into a series of financing transactions structured as capital leases. The equipment, consisting of vans equipped with our mobile gamma cameras, is used by DIS to provide mobile nuclear imaging services. The initial terms of these leases range from 36 to 63 months. The cost of the equipment financed was $1.9 million ($1.6 million of accumulated amortization) at December 31, 2006 and $2.5 million ($1.6 million of accumulated amortization) at December 31, 2005.

Digirad Corporation

Notes to Consolidated Financial Statements—(Continued)

4. Commitments and Contingencies

Leases

We lease our facilities under non-cancelable operating leases that expire through 2010. Rent expense was $1.4 million, $1.1 million and $1.1 million (including common area charges) for the years ended December 31, 2006, 2005 and 2004, respectively. Annual future minimum lease payments as of December 31, 2006 are as follows (in thousands):

	Operating Leases	Capital Leases
2007	$ 1,169	$ 289
2008	904	103
2009	752	—
2010	141	—
Total minimum lease payments	$ 2,966	392
Less amount representing interest		(24)
Present value of future minimum capital lease obligations		368
Less amounts due in one year		(269)
Long-term portion		$ 99

Compliance with Laws and Regulations

We are directly or indirectly through our clients, subject to extensive regulation by both the federal government and the states and foreign countries in which we conduct business. The healthcare laws applicable to us are complex and are subject to variable interpretations. We have established a compliance program to identify any compliance issues, correct any identified issues and assist us in remaining in compliance with the applicable healthcare laws and have instituted other safeguards intended to help prevent any violations of the laws and to remedy any situations that could give rise to violations.

Legal Matters

In the fourth quarter of 2006, we settled two lawsuits alleging failure to pay penalties for missed meal and rest periods, wrongful termination and other tort claims. The amount of the settlements did not have a material impact on our fourth quarter or annual results.

In the normal course of business, we have been and will likely continue to be subject to litigation or administrative proceedings incidental to our business, such as claims related to customer disputes, employment practices, wage and hour disputes, product liability, professional liability, commercial disputes, licensure restrictions or denials, and warranty or patent infringement. Responding to litigation or administrative proceedings, regardless of whether they have merit, can be expensive and disruptive to normal business operations. As litigation and the administrative proceedings are inherently uncertain, we cannot predict the outcome of such matters. We can provide no assurance that the ultimate outcome, either individually or in the aggregate, will not have a material adverse effect on our business or financial results.

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Notes to Consolidated Financial Statements—(Continued)

5. Stockholders' Equity

Initial Public Offering

In June 2004, we completed an initial public offering whereby we sold 5,500,000 shares of common stock at $12 per share and received net proceeds of $58.8 million (after underwriting discounts and commissions and offering expenses).

Preferred stock

Deferred issuance costs for all series of preferred stock totaled approximately $1.0 million and were being accreted up to the redemption value of the related redeemable convertible preferred stock through July 31, 2004 (the earliest redemption date). Upon completion of our initial public offering and the related conversion of all of our outstanding preferred stock to common stock, we ceased accreting up to the redemption value. We recorded accretion of deferred issuance costs on preferred stock of $0.2 million in 2004.

Warrants

At December 31, 2006, 77,525 common stock warrants with a weighted average exercise price of $18.81 per share were outstanding.

Stock Options

At December 31, 2006, we have one stock option plan under which stock options are granted to employees and non-employee members of our Board of Directors, the 2004 Stock Incentive Plan, as Amended and Restated (the "2004 Plan"). During 2006, stockholders approved an amendment to the Plan increasing the number of shares available under the Plan by 1,000,000 shares. At that time, all outstanding grants under our 2005 Inducement Stock Incentive Plan (the "Inducement Plan") were absorbed into the 2004 Plan and the Inducement Plan was terminated. No additional shares are authorized to be issued under the Inducement Plan. Terms of any award of stock options, restricted stock, restricted stock units, stock appreciation rights or dividend equivalent rights under the 2004 Plan, including any vesting requirement (which is generally four years) or term (up to 10 years), are determined by the Board of Directors.

Under the 2004 Plan, we are now authorized to issue an aggregate of 2,400,000 shares of common stock including the additional shares discussed above. The number of shares reserved for issuance under the 2004 Plan is subject to increase by any shares, up to a maximum of 1,500,000 shares (226,664 at December 31, 2006), represented by awards under the 1998 Stock Option/Stock Issuance Plan that are forfeited, expire or are cancelled. At December 31, 2006, we have 541,782 shares available for future issuance under the 2004 Plan.

Prior to the completion of our initial public offering in June 2004, we were authorized to issue options under our 1991 Stock Option Program, 1997 Stock Option/Stock Issuance Plan and 1998 Stock Option/Stock Issuance Plan; however, no additional awards may now be made under such plans. Upon grant, the options under such plan were generally exercisable immediately; however, any exercised but unvested shares remain subject to repurchase by us at the original exercise price.

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Notes to Consolidated Financial Statements—(Continued)

The following table summarizes option activity under our stock option plan (in thousands, except per share amounts):

	Shares	Weighted average exercise price	Average remaining contractual term	Aggregate intrinsic value
Outstanding at January 1, 2006	2,280	$ 5.08		
Granted	943	4.04		
Exercised	(90)	0.49		
Forfeited or expired	(464)	6.75		
Outstanding at December 31, 2006	2,669	$ 4.58	8.12	$ 1,759
Vested or expected to vest at December 31, 2006	2,431	$ 4.58	7.88	$ 1,734
Exercisable at December 31, 2006	1,347	$ 4.58	7.21	$ 1,623

A summary of the status of our nonvested options as of December 31, 2006, and changes during the year ended December 31, 2006, is presented below (in thousands, except per share amounts):

	Shares	Weighted average grant-date fair value
Outstanding at January 1, 2006	1,261	$ 3.64
Granted	943	2.22
Vested	(420)	2.39
Forfeited	(462)	4.45
Outstanding at December 31, 2006	1,322	$ 2.74

The following is a further breakdown of the options outstanding as of December 31, 2006 (in thousands, except per share amounts):

Exercise price	Options outstanding	Weighted average contractual life in years	Weighted average exercise price of options outstanding	Vested options	Weighted average exercise price of vested options
$0.49	456	5.69	$ 0.49	443	$ 0.49
$3.00 - $3.99	370	9.32	3.90	88	3.94
$4.00 - $4.99	879	9.17	4.39	130	4.68
$5.00 - $5.99	790	8.07	5.50	558	5.49
$6.00 - $7.99	25	5.80	6.73	18	6.67
$8.00 - $9.99	109	7.51	8.95	77	8.96
$10.00 - $19.99	38	5.54	10.09	31	10.09
$100.00 - $245.00	1	1.87	216.86	1	216.86
$245.00 - $2,450.00	1	3.52	929.09	1	929.09
$0.49 - $2,450.00	2,669	8.12	$ 4.58	1,347	$ 4.58

Disclosures Pertaining to All Share-Based Compensation Plans

The total intrinsic value of options exercised during years ended December 31, 2006, 2005 and 2004 was approximately $0.3 million, $3.2 million and $25,000, respectively. As of December 31, 2006,

Digirad Corporation

Notes to Consolidated Financial Statements—(Continued)

$2.2 million of total unrecognized compensation cost related to unvested share-based compensation arrangements granted under our various plans is expected to be recognized over a weighted-average period of 2.0 years. Cash received from option exercises for the years ended December 31, 2006, 2005 and 2004 was $53,000, $345,000, and $51,000, respectively. Because of our net operating losses, we did not realize any tax benefits for the tax deductions from share-based payment arrangements during the three years ended December 31, 2006.

Common Shares Reserved for Issuance

The following table summarizes common shares reserved for future issuance at December 31, 2006 (in thousands):

Stock options outstanding	2,669
Stock options available for future grant	542
Warrants	78
Total common shares reserved for issuance	3,289

6. Income Taxes

As of December 31, 2006, we had federal and state income tax net operating loss carry forwards of approximately $84.3 million and $31.3 million, respectively. Federal loss carry forwards of $0.2 million will expire in 2007 unless previously utilized; material federal loss carry forwards do not begin expiring until 2010. During 2006, $14.2 million of state loss carry forwards expired unused; no further material state loss carry forwards will expire until 2012, unless previously utilized. We also have federal and California research and other credit carry forwards of approximately $1.9 million and $1.8 million, respectively. Federal credit carry forwards of $5,000 will expire in 2007 unless previously utilized; material federal credits do not begin expiring until 2012. The California research credits have no expiration. Pursuant to Internal Revenue Code Sections 382 and 383, use of our net operating loss and credit carry forwards may be limited because of a cumulative change in ownership greater than 50% may have occurred. Significant components of our deferred tax assets are shown below (in thousands). A valuation allowance has been recognized to offset the deferred tax assets, as realization of such assets has not met the “more likely than not” threshold required under SFAS No. 109.

	December 31,	
	2006	2005
Deferred tax assets:		
Net operating loss carry forwards	$ 31,009	$ 30,926
Research and development and other credits	3,083	3,083
Reserves	1,542	1,408
Capitalized research and inventory costs	339	283
Other, net	1,889	1,152
Total deferred tax assets	37,862	36,852
Deferred tax liabilities—depreciation	(1,062)	(1,483)
Valuation allowance for deferred tax assets	(36,800)	(35,369)
Net deferred tax assets	$ —	$ —

Digirad Corporation

Notes to Consolidated Financial Statements—(Continued)

7. Segments

Our reporting segments have been determined based on the nature of the products and/or services offered to customers or the nature of their function in the organization. We evaluate performance based on the operating income (loss) contributed by each segment. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies.

Segment data in thousands	Years ended December 31, 2006	2005	2004
Gross profit by segment:			
DIS	$11,939	$ 12,818	$13,285
Product	7,119	2,428	8,474
Consolidated gross profit	$19,058	$ 15,246	$21,759
Income (loss) from operations by segment:			
DIS	$ (4,293)	$ (1,791)	$ 2,168
Product	(3,932)	(9,212)	(1,586)
Consolidated income (loss) from operations	$ (8,225)	$(11,003)	$ 582
Depreciation, amortization and impairment of intangible assets by segment:			
DIS	$ 3,462	$ 3,478	$ 2,167
Product	1,128	1,340	983
Consolidated total	$ 4,590	$ 4,818	$ 3,150

	As of December 31, 2006	2005	2004
Identifiable assets by segment:			
DIS	$14,237	$ 14,141	$15,839
Product	55,040	60,363	70,185
Consolidated assets	$69,277	$ 74,504	$86,024

In 2006 and 2005, we had no foreign sales. In 2004, sales to a customer in Canada represented less than 1% of total revenues for the year.

8. Employee Retirement Plan

We have a 401(k) retirement plan (the “Plan”), under which all full-time employees may contribute up to 100% of their annual salary, within IRS limits. We may make discretionary contributions to the Plan, and contributions for 2006 totaled $158,000 (no contributions were made for 2005 or 2004).

Digirad Corporation

Notes to Consolidated Financial Statements—(Continued)

9. Quarterly Financial Data (Unaudited)

The following financial information reflects all normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of the results of the interim periods. Summarized quarterly data for fiscal 2006 and 2005 are as follows (in thousands, except per share data):

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Fiscal 2006				
Revenues	$18,955	$19,022	$16,702	$17,247
Gross profit	4,393	5,672	4,084	4,910
Loss from operations	(3,300)	(1,636)	(2,685)	(603)
Net loss	(2,804)	(1,203)	(2,134)	(149)
Net loss per common share—basic and diluted (1)	(0.15)	(0.06)	(0.11)	(0.01)
Fiscal 2005				
Revenues	$17,970	$15,462	$17,352	$17,402
Gross profit	5,157	3,411	3,409	3,269
Loss from operations	(1,225)	(3,342)	(3,211)	(3,225)
Net loss	(981)	(3,041)	(2,827)	(2,770)
Net loss per common share—basic and diluted (1)	(0.05)	(0.17)	(0.15)	(0.15)

(1) Earnings per share are computed independently for each of the quarters presented. Therefore, the sum of the quarterly net earnings per share will not necessarily equal the total for the year.

AGREEMENT FOR SERVICES

THIS **AGREEMENT FOR SERVICES** is made and entered into on the 27th day of December, 2006, but effective of the 1st day of February, 2007 (the "Effective Date") by and between **DIGIRAD IMAGING SOLUTIONS, INC.**, a Delaware corporation (the "Client" or "DIS"), and **MBR AND ASSOCIATES, INC.**, a Florida corporation ("MBR").

WHEREAS, MBR is a corporation engaged in the business of providing certain management, financial, billing, collection, accounting, bookkeeping, regulatory compliance, and other related consulting financial services for healthcare clients (generally, the "Services"); and

WHEREAS, the Client is in the healthcare business and has engaged MBR in the past to provide certain selected Services to the Client, and the Client and MBR are willing to continue their business relationship on the terms and conditions set forth herein; and

WHEREAS, Client and MBR have entered into an Agreement for Services dated April 1, 2002 and a First Amendment to Agreement for Services dated March 31, 2005 (the "Previous Agreement"); and

WHEREAS, the parties now wish to enter into a new Agreement for Services (the "Agreement") to supersede the Previous Agreement and all other agreements between them pertaining to the same subject.

NOW, THEREFORE, in consideration of the premises and of the promises and agreements of the parties set forth below, and for other good and valuable consideration, the parties agree as follows:

1. **NEW AGREEMENT**:

A. The Previous Agreement, and all other agreements between the parties pertaining to the same subject, are hereby terminated and superseded in their entirety by the instant Agreement.

2. **SERVICES TO BE RENDERED**:

A. In exchange for the compensation set forth in section 3.A., MBR agrees to provide billing and collections services, including the following designated Services to and for the Client:

(1) Prepare and submit invoices to all customers by either fax, or mail, as directed by the Client or the Client's customers.

(2) Provide month-end billing reports;

(3) Provide invoices, envelopes, and return envelopes;

(4) Update HCPCS and Procedure Codes;

(5) Provide updated HCPCS and Procedure Codes to Client in accordance with CMS policy and procedure.

(6) Post payments and adjustments on a workday basis;

(7) Make bank deposits into Client's account on a workday basis for checks received at MBR;

(8) Review outstanding accounts and advise Client of status on a weekly basis as requested by Client;

(9) Respond within twenty four (24) to forty-eight (48) hours excluding weekends and holidays to telephone and other inquiries from Client relating to billing and collection services;

(10) Enter charge data;

(11) Notify Client immediately in writing of any notices of audit, requests for medical records or other documentation or information out of the normal course of business.;

(12) Assist the Client with any reviews or audits of invoices submitted or billing practices by a federal, state or local regulatory agency. Additional consulting services required for any extraordinary audits will be provided under Section 2.B;

(13) Adopt and comply with a compliance plan, which is consistent with the OIG's Compliance Program Guidance for Third Party Billing Companies, to insure that MBR and MBR's employees abide by all applicable federal and state statutes, regulations, and rules relating to (i) its billing and collecting for all applicable services hereunder, and (ii) maintaining the privacy and confidentiality of patient medical information in its possession;

(14) It is understood that Digirad is required to comply with the Sarbanes-Oxley Act of 2002. MBR will maintain existing, approved internal controls so that Client can review and audit said controls in order to comply with the internal control

requirements of the Sarbanes-Oxley Act of 2002 required of Digirad. Any additional costs needed in order to comply with the Act shall be borne by Digirad.;

(15) Allow Client online access to MBR's PCN Sage system related to MBR's services for Client so as to enable Client to query and to prepare reports. Client will not have access to change data in system without the written permission of MBR so as to maintain the integrity of the system, which permission shall not be unreasonably denied. It is understood that PCN Sage software is proprietary.;

(16) Allow Client access to scanned documents in MBR's E-Bridge electronic data archiving tool as that data and those archiving tools relate to data pertaining to Client and its customers. There will be a cost sharing fee in the range of ***;

(17) Work with Client in investigating a software or other connecting system that may allow MBR's PCN system information data to provide daily updates directly to Client's database. Any costs to be the burden of the client;

(18) Jointly with Client, develop strategies to improve MBR's procedures to improve contracted billing services to enhance their transparency and usefulness to Client's customers, and conduct monthly reviews of such strategies;

(19) Jointly with Client, develop a customer satisfaction process and implement methods of improving results on a continuous basis;

(20) Jointly with Client, develop processes to improve DIS field clean claim performance, including reports by region tracking customer issues.

B. In addition, as part of the compensation set forth in section 3.B., MBR agrees to provide the Client with consultation services in the following areas: CMS regulatory compliance and current Medicare reimbursement updates. All such consulting services shall be requested at the sole discretion of the Client, in writing and may include assistance to and with any extraordinary reviews or audits by a federal, state or local regulatory agency or their contractors beyond responding to normal course of business as listed under Section 2.A.

C. During the term of this Agreement, MBR must retain Client's records in a secure storage facility. MBR must retain electronic copies of all Client's records using data archiving technology, and must allow Client unlimited access to such electronic records upon Client's request. Upon termination or expiration of this Agreement, Client will notify MBR of where to have Client's physical records and copies of its electronic records delivered, and MBR shall complete delivery no later than ninety (90) days after termination. MBR will not be responsible for these records after delivery to the Client.

3. **COMPENSATION TO MBR**:

The Client agrees to pay MBR as follows (all of which fees may be retained by MBR directly from collections received on behalf of the Client):

A. Beginning as of November 1, 2006, at the end of the calendar month (the "Specified Month"), the first such month to be November 2006, MBR shall ***. For Services under Section 2.A, above, MBR shall be entitled to ***.

Client and MBR will diligently work to farther reduce the average days-sales-outstanding (DSO), targeting an average level of ***. The Client and MBR will review the DSO progress on a quarterly basis and assess areas of improvement.

B. For Services under Section 2.B. above and anything outside the other services listed in Section 2, ***, and ***, plus reimbursement of MBR's direct expenses (including travel, room and board, telephone calls, courier charges, equipment, and outside consultants) with respect to such Services. All such services are to be approved, in writing by the Client with receipts for direct expenses.

C. Special projects as agreed between the parties.

MBR will submit monthly or more frequent statements for its Services under this Agreement. Including copies of its calculations of actual revenue collected per month. All amounts billed to the Client under this Section 3 are due and payable by the Client to MBR within *** from the Client's scheduled month-end for the Services performed (or cash collected) by MBR since the prior scheduled month-end, provided that in no event shall payment be due less than ten (10) days from the date the invoice is received. Invoices that are not paid when due will incur a late charge of 1-1/2% per month (or part thereof) of the amount due, except that interest shall not accrue on any amount which is reasonably disputed, provided that all undisputed amounts are paid. In the event any refund occurs after MBR has been paid for such Services, Client shall be entitled to a refund of the fees paid for such Services, which refund shall be credited to next bill not to exceed 30 days, otherwise, refund is to be repaid to Client within thirty days of such refund.

In addition to the foregoing, MBR shall be reimbursed for it's out of pocket expenses for postage and overnight courier and delivery charges that are incurred by MBR in connection with sending

and receiving information for and behalf of Client in connection with MBR's performing the services described in Section 1, including, without limitation, for billing and collection purposes.

4. **TERM**:

The initial term of this Agreement shall be for *** from the Effective Date (the "Initial Term"), and thereafter the term shall automatically renew for consecutive *** unless either party, upon *** written notice prior to the end of the current ***, informs the other party of its intention to terminate the Agreement at the end of the then-current term. After the Initial Term, either party shall have the right to terminate this agreement at anytime, without cause, upon *** written notice. ***. MBR may be requested to remain available to render such Services for the compensation set forth in Section 3 for *** after the termination date. Should the services of MBR need to be extended for *** then a new adjusted termination date will be set and the *** collection period will start from that date at the rate set forth in Section 3. MBR on a reasonable basis will assist in the facilitating of a smooth transition of such Services to the Client or to another person designated by the Client. MBR shall be entitled to its fees on all Services performed by MBR. During the Initial Term and thereafter, either party may terminate this Agreement in the event of a material breach by giving the breaching party written notice and the basis for such termination. This Agreement shall terminate forty-five (45) days after receipt of such notice by certified mail unless such breach is cured within such forty-five (45) day period.

After the termination of this Agreement and the payment of all amounts due MBR, billing and management information and related nonproprietary software, including, without limitation, PCN licensed software (if and only if Client has PCN licensed software) shall be sent to Client with a back-up tape and printed report. A back-up tape of all billing information relating to this Agreement shall be prepared and stored in a safe place by MBR on a weekly or more frequent basis, and MBR shall make these tapes available to Client at no charge upon request. Client, at its expense, reserves the right to review and audit MBR's billings and collections infrastructure, back-up process and any other processes deemed to be more than de minimis in nature and relating to the Client's relationship with MBR. Such review and audit shall be at a time mutually agreed upon by both parties, which agreement shall not be unreasonably withheld.

5. **EXPENSES AND LICENSES**:

Each party is responsible for obtaining and maintaining, at its expense, all licenses, permits, or other items necessary to conduct its business, including all required insurances and bonding.

6. **NON-SOLICITATION; NO HIRING**:

Both parties agree that during the term of this Agreement, and for ninety (90) days thereafter, regardless of the reason for the termination, neither party (nor any affiliate of a party) will hire, or attempt to hire, or solicit for employment, any employee or independent contractor of the other party used in performing the Services.

7. **CONFIDENTIALITY**:

Both parties mutually recognize and acknowledge that the clients, services, and methods of operation are valuable, special, and unique assets of such business. The parties further recognize and acknowledge that all business information, proprietary files, records, analyses, compilations, studies or opinions, financial statements, customer lists, lists of business acquaintances, processes, techniques, services, intellectual property, programming, techniques of application, concepts, purchasing, accounting, marketing, selling, recording of any activity disclosed to each other in connection with MBR's performance under this Agreement are confidential information. Both parties shall keep in strict secrecy and confidence all information that each part assimilated or obtained or to which either party had access during the term of this Agreement for any reason or purpose without the prior written consent of the other party. These terms and conditions shall survive the term of this Agreement.

Each party shall keep confidential all information relating to billing and financial information with respect to the Client and its affiliates, except to the extent reasonably needed to facilitate the services to be rendered under this Agreement or as required by law.

Each party shall comply with all applicable federal and state statutes, regulations and rules relating to privacy and confidentiality of patient medical information.

8. **INSURANCE**:

At all times during the term of this Agreement, MBR shall, at its expense, obtain, keep in force and maintain (i) workers' compensation and (ii) comprehensive or commercial form general liability insurance and errors and omission (contractual liability included) in a form and with an insurance carrier satisfactory to Client, with coverage limits (in the case of the general liability insurance) of at least One Million Dollars ($1,000,000) per occurrence and Two Million Dollars ($2,000,000) annual aggregate. If the above insurance is written on a claims-made form, it shall continue for no less than three (3) years following termination of this Agreement. The coverage and limits described above shall in no way limit any liability of MBR. To the extent available without significant surcharge, MBR will cause Client to be named as an additional insured on MBR's general liability insurance policy. As evidence of MBR's coverage, MBR shall furnish to Client certificates of insurance under these policies prior to the effective date and annually thereafter, which shall include a provision for at least a thirty (30) day prior written notice of cancellation or reduction directed to the attention of both Client and the Compliance Officer. MBR shall maintain and provide Client with evidence of a minimum of One Million Dollars ($1,000,000) fidelity bonding for itself and its employees and Client Personnel involved in the handling of accounting for the monies of Client. The Client shall furnish MBR proof of general liability insurance, errors and omissions insurance, directors insurance and fidelity bonding.

9. **PERSONNEL**:

All personnel providing Services hereunder shall be trained and qualified to perform their applicable duties, and none of them shall be excluded or suspended from Medicare, Medicaid or any other governmental payment program. MBR shall notify Client in the event of the exclusion or suspension of any such personnel whereupon, Client shall have the options of demanding that the affected person(s) be removed immediately, whereupon if MBR does not do so within Thirty (30) days, Client may terminate this Agreement upon written notice.

10. **CLIENT'S OBLIGATIONS**:

A. The Client agrees to make available to MBR all records necessary for performing the Services hereunder. The Client will communicate with MBR, in a timely manner, as reasonably necessary for MBR to perform the Services hereunder, provided that all such communications between the parties will be in writing. If the information delivered by Client is insufficient, MBR may contact Client's customer for further details or return the documentation to Client for completion. Ultimately, the Client is responsible for ensuring correct information is given to MBR for processing.

B. The Client agrees to maintain a checking account reasonably acceptable to MBR to be exclusively for business purposes and into which collections made hereunder shall be deposited.

C. The Client agrees that MBR is its exclusive agent for billing and collecting its accounts and that it will provide to MBR all accounts accumulated in its business during the term of this Agreement for processing by MBR. Client agrees to provide complete information necessary to bill each physician and/or facility.

D. The Client authorizes MBR to provide training to the employees of Client, identified by Client, who are responsible for data collection, copying, and forwarding to MBR. Such training will be part of the set-up cost and be provided at no additional cost to the Client's employees at the time of execution of this Agreement.

E. The Client agrees that it will not market, broker, sell, or re-sell MBR's services to any other person (including, without limitation, customers or clients of the Client) without MBR's prior written consent.

11. **CLIENT'S REPRESENTATIONS**:

Client represents, warrants, and covenants that

A. Client is duly organized and exists in good standing under the laws of the State of Delaware and is qualified to do business in each state in which Client is required to be so qualified.

B. Neither the execution nor the consummation of the transactions contemplated by this Agreement will conflict with or result in a breach of performance required by the provisions for any other agreement or contract to which the Client is a party.

C. Client has adopted a compliance plan or plans to assist Client and Client's employees in abiding by all applicable federal and state statutes, regulations, and rules relating to (i) its providing or arranging for healthcare services, (ii) its marketing to its customers and prospective customers, (iii) its billing and collecting for all such services, and (iv) maintaining the privacy and confidentiality of patient medical information in its possession.

D. None of Client's employees, contractors, clients, or customers is, has been, or will be, during the term of this Agreement, excluded or suspended from Medicare, Medicaid, or any other governmental payment program. The Client will include in its contracts with all physicians under which MBR shall bill and collect for such services entered into after April 15, 2001 physician representation language that the physicians and any of their participating personnel in the services under contract, are not excluded or suspended from Medicare, Medicaid or any other governmental payment programs.

12. **INDEPENDENT CONTRACTOR STATUS**:

It is understood and agreed that the services of MBR have been and will be rendered as an independent contractor and not as an employee, agent, or representative of Client. In this regard, neither MBR nor any of its employees or agents shall be deemed for purposes of this Agreement to be employed by Client for purposes of any tax or contribution levied by the Federal Social Security Act or any corresponding state law with respect to employment or compensation for employment, and MBR will file all forms and pay all taxes and other amounts required of an independent contractor.

MBR shall have complete control over its method of providing services, subject to the requirements of this Agreement and applicable law. Client will not exercise direct or implied authority over MBR in its work nor shall it have supervisory power over MBR or any of its employees or agents, other than to assure MBR's adherence to the terms of this Agreement. Neither party shall have any responsibility for, or liability as a result of, any action, inaction, error or omission by the other.

13. **REVIEWS AND AUDITS**:

Client shall, upon reasonable notice and conditions, be allowed to review any and all of the documentation, procedures and information concerning Client's billing and to appoint a third party consultant to review such billing on the premises of MBR, all at Client's sole expense. MBR agrees to cooperate with any review. MBR may impose reasonable standards and restrictions on any such audit and review to insure the privacy or patient medical information of patients who are not Client's patients. MBR will review any reports upon such billing procedures, suggestions for improvement or otherwise and will exercise good faith in maintaining an acceptable level of efficiency and accuracy in its billing procedures. Any and all information obtained under review shall be kept confidential except as required to comply with Client's legal obligations.

14. **INDEMNIFICATION**:

Each party (the "Indemnifying Party") hereby agrees to indemnify and hold the other party, including its directors, officers, shareholders, employees, and agents (collectively the "Indemnified Party") harmless from and against any losses, claims, damages, or expenses, and all reasonable costs of prosecution or defense regarding its rights hereunder, whether in judicial proceedings, including appellate proceedings, or out of court, including, without limiting the generality of the foregoing, attorneys' fees and all costs and expenses of litigation (collectively, a "Loss"), arising from or growing out of a material violation of the terms of this Agreement or negligent or willful misconduct by the Indemnifying Party.

15. **MEDIATION AND ARBITRATION**:

It is the intention of all parties that no dispute under this Agreement or with respect to relationship between parties will be the subject of any court action or litigation in the local, state, or federal judicial system. The parties recognize that the problem resolution processes of mediation and arbitration are appropriate and preferable to resolve issues between the parties. If any party hereto wishes to resolve an issue under or relating to this Agreement, then such party must give notice of a request for mediation to the other parties, which notice shall set forth the names of not less than three (3) mediators from the panel of JAMS/Endispute or the American Arbitration Association or other mutually agreed upon alternative dispute resolution service in Hillsborough County if mediation is commenced by Digirad or in San Diego County if mediation is commenced by MBR. The party receiving such notice shall agree upon one or more such mediators with ten (10) days of receipt of such notice and a mediation will be scheduled as soon as feasible between the parties and their respective advisors, and the parties and their advisors will cooperate fully with respect to sharing of information and attendance at meetings in order to seek resolution. The parties will share mediation expenses with the party requesting the mediation, paying one-half of such expense of the mediator fees and the other party paying the other one-half of such expenses. If resolution of the matters between the parties cannot be resolved in mediation within twenty (20) days of the selection of a mediator by the party receiving such notice, then the matter shall be presented to formal arbitration pursuant to the rules utilized by the alternative dispute resolution service selected by an arbitrator from such

service's panel agreed upon by the parties or, if the parties are unable to agree upon an arbitrator within ten (10) days of the completion of mediation, by a panel of three (3) arbitrators from such panel selected by such service's administrator. Arbitration shall take place in the venue in which the mediation shall have occurred as soon as possible and the decision of the arbitrator panel shall be binding upon the parties for all purposes. The party which does not prevail in such proceeding or in any judicial proceeding shall pay all reasonable fees and costs, including attorneys' and expert witness fees, incurred by the prevailing party relating to such proceeding, except that the arbitrator shall have discretion to reduce or eliminate such award of costs and fees if such award would be inequitable or unreasonable under the circumstances. It is the intention of the parties that this Agreement shall be construed and interpreted in a fair and equitable manner based upon the facts and circumstances of the parties taking into account the present intention of the parties to have a fair and equitable agreement under the terms and conditions set forth in this Agreement.

16. **ENFORCEMENT**:

Each covenant shall be construed as a covenant independent of any other covenant or provision of this Agreement or any other Agreement which MBR and Client may have, and the existence of any claim or cause of action of one party against the other, whether predicated on this Agreement or otherwise, shall not constitute a defense to the enforcement of such covenants.

17. **TERMINATION**:

During the term of this Agreement, MBR may retain Client's records in an off-site storage facility. Upon termination or expiration of this Agreement, Client will notify MBR of where to have its records delivered after the ninety-day (90) collection period. MBR will not be responsible for these records after delivery to the Client.

18. **ADDITIONAL COVENANTS OF MBR**:

MBR covenants that it has and will maintain its expertise, procedures and employee training with respect to billing and reimbursement issues, coding, maximizing revenues in a prudent manner, and other billing related activities. MBR agrees to provide monthly reporting of billings, receipts, aged receivables, as are requested by the Client on a reasonable basis. MBR will maintain such insurances with reputable insurance carriers in such amounts and upon terms that are deemed reasonable and appropriate.

19. **COMPLIANCE WITH THE HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996**.

The parties acknowledge that Client is subject to the Administrative Simplification requirements of the Health Insurance Portability and Accountability Act of 1996 and regulations promulgated thereunder ("HIPAA"), including but not limited to, the Standards for Privacy of Individually Identifiable Health Information, 45 CFR Parts 160 and 164; and that HIPAA

mandates that Client require MBR to provide for the protection of the privacy and security of Health Information. Accordingly, MBR shall provide such protection as required by this Agreement.

A. Definitions. The following terms shall be defined as follows:

(1) "Disclose" and "Disclosure" mean, with respect to Health Information, the release, transfer, provision of access to, or divulging in any other manner of Health Information outside MBR's internal operations or to other than its employees.

(2) "Health Information" means information that (a) relates to the past, present or future physical or mental health or condition of an individual; the provision of health care to an individual; (b) identifies the individual (or for which there is a reasonable basis for believing that the information can be used to identify the individual); and (c) is received by MBR from or on behalf of Client or is created by MBR, or is made accessible to MBR by Client.

(3) "Privacy Regulations" means the Standards for Privacy of Covered Individually Identifiable Health Information, 45 CFR Parts 160 and 164, promulgated under HIPAA.

(4) "Services" means the services provided by MBR pursuant to this Agreement.

(5) "Use" or "Uses" means, with respect to Health Information, the sharing, employment, application, utilization, examination or analysis of such Health Information within MBR's internal operations.

B. Permitted Uses and Disclosures of Health Information. MBR is authorized to do the following:

(1) Use and Disclose Health Information as necessary to perform Services for, or on behalf of Client;

(2) Use Health Information to create aggregated or de-identified information (in accordance with the requirements of the Privacy Regulations);

(3) Use or Disclose Health Information (including aggregated or de-identified information) as otherwise directed by Client provided that Client shall not request MBR to Use or Disclose Health Information in a manner that would not be permissible if done by Client;

(4) Use and Disclose Health Information as required by law.

C. Other Uses of Health Information. MBR may use Health Information for the proper management and administration of MBR or to carry out its legal responsibilities. MBR may Disclose Health Information for the proper management and administration of MBR, provided that with respect to any such Disclosure either (1) the Disclosure is required by law (within the meaning of the Privacy Regulations) or (2) MBR obtains reasonable assurance from the person to whom the information is to be Disclosed that such person will hold the information in confidence and will not Use or further Disclose such information except as required by law or for the purpose(s) for which it was Disclosed by MBR to such person, and that such person will notify MBR of any instances of which it is aware in which the confidentiality of the information has been breached.

D. Adequate Safeguards for Health Information. MBR warrants that it shall implement and maintain appropriate safeguards to prevent the Use or Disclosure of Health Information in any manner other than as permitted herein or by law.

E. Mitigation. MBR agrees to mitigate, to the extent practicable, any harmful effect that is known to MBR of a Use or Disclosure of Health Information by MBR in violation of the requirements of this Agreement.

F. Reporting Non-Permitted Use or Disclosure. MBR shall not Use or Disclose Health Information except as permitted by this Agreement or as required by law. MBR shall report to Client a Use or Disclosure that is made by MBR that is not permitted by this Agreement or which MBR becomes aware.

G. Availability of Internal Practices, Books, and Records. MBR agrees to make its internal practices, books and records relating to the Use and Disclosure of Health Information available to the Secretary of the Secretary for purposes of determining Client's compliance with the Privacy Regulations.

H. Access to and Amendment of Health Information. MBR shall, to the extent Client determines that any Health Information constitutes a "designated records set" of Client under the Privacy Regulations, (a) make the Health Information specified by Client available to Client or to the individual(s) identified by Client as being entitled to access and copy that Health Information, and (b) make any amendments to Health Information that are requested by Client.

I. Use of Subcontractors and Agents. MBR shall require each of its agents and subcontractors that receive Health Information from MBR to comply with this Section 19 of this Agreement with respect to such Health Information.

J. Privacy Notice. Client shall notify MBR of any limitations(s) in Client's notice of privacy practices to the extent such limitation(s) may affect MBR's Use or Disclosure of Health Information.

K. Changes or Restrictions. Client shall notify MBR of any changes in permission by an individual to use or disclose Health Information to the extent such change may affect MBR's Use or Disclosure of Health Information. Client shall notify MBR of any restriction to which Client agrees that may affect MBR's Use or Disclosure of Health Information.

L. Disposition of Health Information Upon Termination or Expiration. Upon termination or expiration of this Agreement, MBR shall either return or destroy all Health Information in the possession or control of MBR and its agents and subcontractors. In such event, MBR shall retain no copies of such Health Information. However, if MBR determines that neither return nor destruction of Health Information is feasible, MBR shall notify Client of the conditions that make return or such destruction infeasible, and may retain Health Information provided that MBR (1) continues to comply with the provisions related to the protection of Health Information for as long as it retains Health Information, and (2) further limits the Uses and Disclosures of Health Information to those purposes that make the return or destruction of Health Information infeasible.

M. Amendments to Comply With Law. The parties acknowledge that state and federal laws relating to electronic data security and privacy are rapidly evolving and that amendment of this Agreement may be required to provide for procedures to ensure compliance with such developments. The parties specifically agree to take such actions as is necessary to implement the standards and requirements of HIPAA and other applicable laws relating to the security or confidentiality of Health Information.

20. **MISCELLANEOUS**:

A. This Agreement shall constitute the entire agreement of the parties and takes the place of the prior written agreements between the parties "Prior Agreement" as of the Effective Date, except that MBR's compensation as set forth is Section 3,shall be effective as of Nov 1, 2006. It may not be changed orally, but only by agreement in writing signed by both parties.

B. Any notice required or permitted to be given under this Agreement shall be sufficient if in writing and if sent by (i) certified or registered mail, return receipt requested, (ii) hand delivery or overnight courier with proof of delivery, or (iii) facsimile transmission with confirmation of receipt, to the parties as follows:

If to MBR: 4519 George Road, Suite 100
Tampa, Florida 33634
Facsimile No.: (813) 496-8546
ATTENTION: Becky Cacciatore, President

If to Client: 13950 Stowe Drive
Poway, California 92064
Facsimile No.: (858) 726-1700
ATTENTION: CEO OR CHIEF FINANCIAL OFFICER

C. The rights and obligations of the parties under this Agreement shall inure to the benefit of and shall be binding upon their respective heirs, executors, administrators, sublessors and assigns. No party may assign any of its rights, obligations or interest in this Agreement without the prior written consent of all parties to this Agreement.

D. This Agreement shall be governed by the laws of the State of California.

E. This Agreement shall be deemed to have been "executed" when the last party to sign this Agreement has affixed his, her or its signature at the end of this Agreement.

F. All parties to this Agreement specifically agree to act in good faith in interpreting this Agreement and in carrying out their respective duties and obligations hereunder.

G. This Agreement may be executed in multiple counterparts, each of which shall be considered an original, and all of which shall constitute but a single agreement notwithstanding that each such counterpart is executed on a different date.

H. Because each party has participated fully in the drafting and preparation of this Agreement, the Agreement shall not be construed more strongly against any party.

I. Each party to this Agreement hereby acknowledges and confirms that he, she or it has had an opportunity to retain independent legal counsel to independently advise that part of the legal consequences of the Agreement to the party. Each party to this Agreement further acknowledges and confirms that each such party received the strong recommendation by all other parties to the Agreement that each party should retain separate and independent legal counsel to advise each party of the legal consequences of the Agreement to that party.

J. All prior negotiations and/or oral agreements between the parties and/or two or more of the parties hereby are merged and extinguished into this Agreement.

K. Unless otherwise expressly provided in this Agreement, all rights, obligations and other terms and conditions specifically stated in this Agreement shall survive the execution of this Agreement.

L. If any one or more of the provisions contained in this Agreement for any reason are held to be invalid, illegal, or unenforceable in any respect, such invalidity, illegality or unenforceability shall not affect any other provision hereof and this Agreement shall be construed as if such invalid, illegal or unenforceable provision had never been contained herein.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement on the day and year first set forth above.

MBR AND ASSOCIATES, INC.	**DIGIRAD IMAGING SOLUTIONS, INC.**
By: _____	By: _____
Name: _____	Name: _____
Title: _____	Title: _____

EXHIBIT 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements (Form S-8 Nos. 333-116345 and 333-129609) of Digirad Corporation of our reports dated February 16, 2007 with respect to: (1) the consolidated financial statements and schedule of Digirad Corporation, and (2) Digirad Corporation management's assessment of the effectiveness of internal control over financial reporting, and the effectiveness of internal control over financial reporting of Digirad Corporation, included in the Annual Report (Form 10-K) for the year ended December 31, 2006.

/s/ Ernst & Young LLP

San Diego, California
February 16, 2007

EXHIBIT 31.1

CERTIFICATION OF
PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002

I, Mark L. Casner, certify that:

1. I have reviewed this annual report on Form 10-K of Digirad Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15(d)-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

February 16, 2007

/s/ MARK L. CASNER

Mark L. Casner
President and Chief Executive Officer
(Principal Executive Officer)

EXHIBIT 31.2

CERTIFICATION OF
PRINCIPAL FINANCIAL OFFICER
PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002

I, Todd P. Clyde, certify that:

1. I have reviewed this annual report on Form 10-K of Digirad Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15(d)-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

February 16, 2007

/s/ TODD P. CLYDE

Todd P. Clyde
Chief Financial Officer
(Principal Financial Officer)

EXHIBIT 32.1

CERTIFICATION OF
PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350
(SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002)

In connection with the accompanying Annual Report on Form 10-K of Digirad Corporation for the year ended December 31, 2006, I, Mark L. Casner, Chief Executive Officer of Digirad Corporation, hereby certify pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

(1) such Annual Report on Form 10-K of Digirad Corporation for the year ended December 31, 2006, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) the information contained in such Annual Report on Form 10-K of Digirad Corporation for the year ended December 31, 2006, fairly presents, in all material respects, the financial condition and results of operations of Digirad Corporation at the dates indicated.

This certification has not been, and shall not be deemed, "filed" with the Securities and Exchange Commission.

February 16, 2007

/s/ MARK L. CASNER

Mark L. Casner
President and Chief Executive Officer
(Principal Executive Officer)

A signed copy of this written statement required by Section 906 has been provided to Digirad Corporation and will be retained by Digirad Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

EXHIBIT 32.2

CERTIFICATION OF
PRINCIPAL FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350
(SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002)

In connection with the accompanying Annual Report on Form 10-K of Digirad Corporation for the year ended December 31, 2006, I, Todd P. Clyde, Chief Financial Officer of Digirad Corporation, hereby certify pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

(1) such Annual Report on Form 10-K of Digirad Corporation for the year ended December 31, 2006, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) the information contained in such Annual Report on Form 10-K of Digirad Corporation for the year ended December 31, 2006, fairly presents, in all material respects, the financial condition and results of operations of Digirad Corporation at the dates indicated.

This certification has not been, and shall not be deemed, "filed" with the Securities and Exchange Commission.

February 16, 2007

/s/ TODD P. CLYDE

Todd P. Clyde
Chief Financial Officer
(Principal Financial Officer)

A signed copy of this written statement required by Section 906 has been provided to Digirad Corporation and will be retained by Digirad Corporation and furnished to the Securities and Exchange Commission or its staff upon request.