

CHAD THERAPEUTICS INC

Form 10-Q

February 14, 2008

**Table of Contents**

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

**Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For Quarterly Period Ended: December 31, 2007**  
**Or**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**Commission file number: 1-12214**  
**CHAD THERAPEUTICS, INC.**  
(Exact name of registrant as specified in its charter)

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

21622 Plummer Street, Chatsworth, CA 91311  
(Address of principal executive offices) (Zip Code)  
(818) 882-0883  
(Registrant's telephone number, including area code)

(Former Address)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company   
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No   
As of December 31, 2007, the registrant had 10,180,000 shares of its common stock outstanding.

**Table of Contents**

CHAD THERAPEUTICS, INC.  
Condensed Balance Sheets  
December 31, 2007 and March 31, 2007  
(Unaudited)

	December 31, 2007	March 31, 2007
<b>ASSETS</b>		
Current assets:		
Cash	\$ 261,000	\$ 375,000
Accounts receivable, less allowance for doubtful accounts of \$25,000 at December 31, 2007, and \$38,000 at March 31, 2007	1,470,000	2,376,000
Income taxes refundable	2,000	291,000
Inventories (Note 5)	6,140,000	6,557,000
Prepaid expenses and other assets	319,000	321,000
Total current assets	8,192,000	9,920,000
Property and equipment, at cost	6,337,000	6,186,000
Less accumulated depreciation	5,726,000	5,501,000
Net property and equipment	611,000	685,000
Intangible assets, net	1,071,000	1,107,000
Other assets	262,000	36,000
Total assets	\$ 10,136,000	\$ 11,748,000
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,507,000	\$ 1,282,000
Accrued expenses	1,090,000	1,372,000
Revolving line of credit	1,168,000	
Current portion of long-term debt	292,000	
Total current liabilities	4,057,000	2,654,000
Long-term debt	390,000	
Total liabilities	4,447,000	2,654,000
Shareholders' equity:		
Common shares, \$.01 par value, authorized 40,000,000 shares; 10,180,000 and 10,180,000 shares issued and outstanding	13,632,000	13,526,000
Accumulated deficit	(7,943,000)	(4,432,000)

Edgar Filing: CHAD THERAPEUTICS INC - Form 10-Q

Total shareholders' equity	5,689,000	9,094,000
Total liabilities and shareholders' equity	\$ 10,136,000	\$ 11,748,000

See accompanying notes to condensed financial statements.

---

**Table of Contents**

CHAD THERAPEUTICS, INC.  
 Condensed Statements of Operations  
 For the three months ended December 31, 2007 and 2006  
 (Unaudited)

	Three Months Ended December 31,	
	2007	2006
Net sales	\$ 2,929,000	\$ 4,307,000
Cost of sales	1,770,000	3,248,000
Gross profit	1,159,000	1,059,000
Costs and expenses:		
Selling, general, and administrative	1,537,000	1,421,000
Research and development	359,000	396,000
Total costs and expenses	1,896,000	1,817,000
Operating loss	(737,000)	(758,000)
Interest expense	131,000	
Other income		18,000
Loss before income taxes	(868,000)	(740,000)
Income tax expense (benefit)		(305,000)
Net loss	\$ (868,000)	\$ (435,000)
Basic loss per share	\$ (0.09)	\$ (0.04)
Diluted loss per share	\$ (0.09)	\$ (0.04)
Weighted shares outstanding:		
Basic	10,180,000	10,169,000
Diluted	10,180,000	10,169,000
See accompanying notes to condensed financial statements.		

**Table of Contents**

CHAD THERAPEUTICS, INC.  
Condensed Statements of Operations  
For the nine months ended December 31, 2007 and 2006  
(Unaudited)

	Nine Months Ended December 31,	
	2007	2006
Net sales	\$ 10,108,000	\$ 14,766,000
Cost of sales	7,555,000	10,276,000
Gross profit	2,553,000	4,490,000
Costs and expenses:		
Selling, general, and administrative	4,494,000	4,805,000
Research and development	1,212,000	1,053,000
Total costs and expenses	5,706,000	5,858,000
Operating loss	(3,153,000)	(1,368,000)
Interest expense	306,000	
Other (income) expense	48,000	(57,000)
Loss before income taxes	(3,507,000)	(1,311,000)
Income tax expense (benefit)	4,000	(453,000)
Net loss	\$ (3,511,000)	\$ (858,000)
Basic loss per share	\$ (0.34)	\$ (0.08)
Diluted loss per share	\$ (0.34)	\$ (0.08)
Weighted shares outstanding:		
Basic	10,180,000	10,169,000
Diluted	10,180,000	10,169,000
See accompanying notes to condensed financial statements.		

**Table of Contents**

CHAD THERAPEUTICS, INC.  
 Condensed Statement of Shareholders' Equity  
 For the nine months ended December 31, 2007  
 (Unaudited)

	Common Shares		Accumulated Deficit
	Shares	Amount	
Balance as of March 31, 2007	10,180,000	13,526,000	\$ (4,432,000)
Stock-based compensation - options		8,000	
Warrants		98,000	
Net loss			(3,511,000)
Balance at December 31, 2007	10,180,000	13,632,000	\$ (7,943,000)

See accompanying notes to condensed financial statements.

---

**Table of Contents**

CHAD THERAPEUTICS, INC.  
Condensed Statement of Cash Flows  
For the nine months ended December 31, 2007 and 2006  
(Unaudited)

	Nine Months Ended December 31,	
	2007	2006
Cash flows from operating activities:		
Net loss	\$ (3,511,000)	\$ (858,000)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization of property and equipment	225,000	272,000
Amortization of intangibles	30,000	32,000
Loss on impairment of intangible assets	48,000	
Amortization of deferred financing fees	62,000	
Provision for losses on receivables	(14,000)	(9,000)
Decrease (increase) in deferred income taxes		(170,000)
Stock-based compensation	8,000	67,000
Warrant costs	98,000	
Changes in assets and liabilities:		
Decrease (increase) in accounts receivable	920,000	990,000
Decrease (increase) in inventories	417,000	(387,000)
Decrease (increase) in income taxes refundable	289,000	83,000
Decrease (increase) in prepaid expenses and other assets	(286,000)	(89,000)
Increase (decrease) in accounts payable	225,000	617,000
Increase (decrease) in accrued expenses	(282,000)	(175,000)
Net cash (used in) provided by operating activities	(1,771,000)	373,000
Cash flows from investing activities:		
Additions to intangible assets	(42,000)	(154,000)
Capital expenditures	(151,000)	(73,000)
Net cash (used in) provided by investing activities	(193,000)	(227,000)
Cash flows from financing activities:		
Borrowings under revolving line of credit	1,168,000	
Borrowings under long term debt	750,000	
Payments on long term debt	(68,000)	(11,000)
Net cash (used in) provided by financing activities	1,850,000	(11,000)
Net increase (decrease) in cash	(114,000)	135,000
Cash beginning of period	375,000	935,000
Cash end of period	\$ 261,000	\$ 1,070,000
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Interest	\$ 211,000	\$

See accompanying notes to condensed financial statements.

---

**Table of Contents**

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

1. **Basis of Presentation and Going Concern**

CHAD Therapeutics, Inc. (the Company) is in the business of developing, producing, and marketing respiratory care devices designed to improve the efficiency of oxygen delivery systems for home health care and hospital treatment of patients suffering from pulmonary diseases.

In the opinion of management, all adjustments necessary, which are of a normal and recurring nature, for a fair presentation of the results for the interim periods presented, have been made. The results for the three and nine-month periods ended December 31, 2007, are not necessarily indicative of the results expected for the year ended March 31, 2008. The interim statements are condensed and do not include some of the information necessary for a more complete understanding of the financial data. Accordingly, your attention is directed to the footnote disclosures found in the March 31, 2007, Annual Report and particularly to Note 1 which includes a summary of significant accounting policies.

The Company's financial statements have been prepared and presented on a basis assuming it will continue as a going concern. However, the Company's prospects must be considered in light of substantial risks. The Company has experienced net losses since its fiscal year ended March 31, 2006 and as of December 31, 2007, it had an accumulated deficit of approximately \$7,943,000. For the nine months ended December 31, 2007, the Company had a net loss of \$3,511,000 and utilized approximately \$1,771,000 of cash in operating activities. The Company expects operating losses to continue through its foreseeable future. At the filing date, the Company had utilized substantially all of the financing available through its revolving line of credit and its term note. These factors, among others, indicate that the Company is in need of additional financing or a strategic arrangement in order to continue operations. These factors could raise doubts about the Company's ability to continue as a going concern.

In order to address this situation, on November 16, 2007, the Company entered into a definitive agreement, subject to shareholder approval, to sell to Inovo, Inc. (the Buyer) substantially all of the assets of the Company related to the oxygen conserver business including accounts receivable, inventory, and certain equipment and intellectual property (the Asset Sale) pursuant to an Asset Purchase Agreement (the APA). Pursuant to the APA, the Buyer would assume certain liabilities and obligations related to the Company's oxygen conserver business. The Company's shareholders voted to approve the sale of the Company's oxygen conserver business on January 31, 2008. The Asset Sale is scheduled to be completed on February 15, 2008. Once the Asset Sale is completed, the Company will no longer develop and sell oxygen conserver products. The Company will retain the assets related to its TOTAL O2 and in-home transfilling business as well as products in development for the sleep disorder market. The Company is currently seeking to sell its in-home trans-filling business. The Company intends to focus its future efforts on the sleep disorder market.

---

**Table of Contents**

The selling price for the conservator assets is \$5,250,000, subject to adjustment for changes in working capital between the execution date of the APA and closing date (the Selling Price ). The selling price may not exceed \$5,500,000. There is no limit on a potential downward adjustment of the selling price based on a reduction in the working capital as defined the APA.

On January 2, 2008, CHAD Therapeutics Inc. (the Company ) entered a Subordinated Secured Note and Warrant Purchase Agreement (the Credit Facility ) with Mr. Earl Yager and Mr. Thomas Jones, our Chief Executive Officer and our Chairman of the Board, respectively. The Company entered into the financing arrangement after it was unsuccessful in obtaining financing on acceptable terms from a third party. The terms of the financing arrangement were negotiated and approved by the Company s independent directors who concluded that the terms were more favorable to the Company than those available from third party lenders. Pursuant to the terms of the Credit Facility, the Company may draw an aggregate of \$1,000,000, subject to certain conditions. As of February 12, 2008, the Company had borrowed \$550,000 under this facility.

Notes issued under the Credit Facility bear interest at a rate of 8% per annum and will mature at the earlier of (i) two business days after the closing of the APA with Inovo, or (ii) August 30, 2010. The notes are secured by a lien on the assets of the Company, which is subordinated to the security interest of Calliope Capital Corporation discussed in Note 6 below.

In connection with the Credit Facility, Mr. Yager and Mr. Jones received 321,428 warrants to purchase our common stock at a price per share equal to \$ .28 (the average closing price of our common stock on the American Stock Exchange for the five days immediately preceding the initial funding under the Credit Facility. The warrants have a term of five years. No additional warrants are issuable in connection with any additional borrowings the Company may make under the Credit Facility.

If the Asset Sale to Inovo closes during the first calendar quarter of 2008, then the Company anticipates it will have sufficient working capital in place for the next 12 months to continue operations. If the Asset Sale is not completed during the first calendar quarter of 2008, then the Company would require additional capital resources which may only be available pursuant to terms and conditions that would result in significant cost to the Company and significant dilution of the shareholders interest in the Company and its assets. Moreover, such additional financing may not be available at all, in which event the Company would need to consider other alternatives, including an orderly liquidation of its assets, curtailment of its current operations and seeking protection under the federal bankruptcy laws. The financial statements do not include any adjustments that might be required for the outcome of this uncertainty.

2. **Revenue Recognition**

Revenue from product sales is recognized upon shipment of merchandise when title and risk of loss transfers to the customer and the earnings process is complete. Products are shipped FOB shipping point and title to the products transfers to the purchaser upon shipment. Under a sales-type lease agreement, revenue is recognized at the time of the shipment with interest income recognized over the life of the lease.

---

**Table of Contents**

Shipping charges billed to customers are included in net sales. Allowances for customer returns have not been established, as historically customer return experience has been minor. Costs paid to shipping companies are recorded as a cost of sales.

**3. Major Customers**

	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	2007	2006	2007	2006
Customer A**	32.6%	43.9%	39.1%	39.7%

\*\* Indicates  
national chain  
customer

The Company's customers are affected by Medicare reimbursement policy as approximately 80% of home oxygen patients are covered by Medicare and other government programs.

**4. Concentration of Credit Risk**

At times the Company maintains balances of cash that exceed \$100,000 per financial institution, the maximum insured by the Federal Deposit Insurance Corporation. Further, the Company maintains a portion of its cash funds in an interest bearing, uninsured account. The Company's right to the cash is subject to the risk that the financial institution will not pay when cash is requested. The potential loss is the amount in any one financial institution over \$100,000 and/or all funds in the interest bearing account. At December 31, 2007, the amount at risk was approximately \$261,000.

The significant outstanding accounts receivable balances in 2007 were as follows:

	December	March 31
	31	
Customer A**	24.8%	41.0%
Customer B**	14.4%	*

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

\*\* Indicates  
national chain  
customer.

**5. Inventories**

Inventories in 2007 are summarized as follows:

Edgar Filing: CHAD THERAPEUTICS INC - Form 10-Q

	December 31	March 31
Finished goods	\$ 2,120,000	\$ 1,841,000
Work-in-process	1,837,000	2,240,000
Raw materials	2,183,000	2,476,000
	\$ 6,140,000	\$ 6,557,000

---

**Table of Contents**6. Long-Term Debt and Revolving Line of Credit

Long-term debt in 2007 consists of the following:

	December 31	March 31
Long-term note	682,000	
Less current portion	292,000	
Total long-term debt	\$ 390,000	\$

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

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

On January 2, 2008, CHAD Therapeutics Inc. (the "Company") entered a Subordinated Secured Note and Warrant Purchase Agreement (the "Credit Facility") with Mr. Earl Yager and Mr. Thomas Jones, our Chief Executive Officer and our Chairman of the Board, respectively. The Company entered into the financing arrangement after it was unsuccessful in obtaining financing on acceptable terms from a third party. The terms of the financing arrangement were negotiated and approved by the Company's independent directors who concluded that the terms were more favorable to the Company than those available from third party lenders.

**Table of Contents**

Pursuant to the terms of the Credit Facility, the Company may draw an aggregate of \$1,000,000, subject to certain conditions. As of February 12, 2008, the Company had borrowed \$550,000 under this facility.

Notes issued under the Credit Facility bear interest at a rate of 8% per annum and will mature at the earlier of (i) two business days after the closing of the APA with Inovo, or (ii) August 30, 2010. The notes are secured by a lien on the assets of the Company, which is subordinated to the security interest of Calliope Capital Corporation.

In connection with the Credit Facility, Mr. Yager and Mr. Jones each received 321,428 warrants to purchase our common stock at a price per share equal to \$.28 (the average closing price of our common stock on the American Stock Exchange for the five days immediately preceding the initial funding under the Credit Facility). The number of shares issuable for each warrant will be equal to (a) the principal amount of the Note issued at the Initial Closing multiplied by 0.30, divided by (b) the Exercise Price. The warrants have a term of five years. No additional warrants are issuable in connection with any additional borrowings the Company may make under the Credit Facility.

For the nine months ended December 31, 2007, amortization of deferred financing fees was \$62,000. There were no deferred financing fees in fiscal year 2006.

7. **Subsequent Event**

On January 31, 2008, the Company's shareholders approved the sale of the Company's conserved assets to Inovo pursuant to the APA and the sale is scheduled to close on February 15, 2008.

Upon close of the Asset Sale, the Company will no longer obtain revenues from sales of CHAD oxygen conserving devices. Such revenues were approximately 93% and 80% and 93% and 90% of the Company's revenues for the three and nine-month periods ended December 31, 2007, and 2006, respectively. The remaining revenues were derived from the sale of the Company's TOTAL O2 and in-home transfilling products. The Company is currently seeking to sell such business. The Company intends to focus its efforts on the development and commercialization of diagnostic and therapeutic products for the sleep disorder market.

8. **Leasing Arrangements**

In the second quarter of fiscal year 2006, the Company entered into a capital lease agreement for certain plant equipment totaling \$14,000, with annual lease payments of \$7,000, a fixed interest rate of 7% and a purchase option at lease end in August 2007. The Company completed the capital lease obligation in September 2007 and exercised the bargain purchase option at that time. Amortization of plant equipment under capital leases is included in depreciation expense.

9. **Loss Per Common Share**

Following is a reconciliation of the numerators and denominators used in the calculation of basic and diluted loss per common share:

---

**Table of Contents**

	Three Months Ended December 31		Nine Months Ended December 31,	
	2007	2006	2007	2006
Basic loss per share:				
Numerator-net loss	\$ (868,000)	\$ (435,000)	\$ (3,511,000)	\$ (858,000)
Denominator-weighted average common shares outstanding	10,180,000	10,169,000	10,180,000	10,169,000
Basic earnings loss per share	\$ (0.09)	\$ (0.04)	\$ (0.34)	\$ (0.08)
Diluted loss per share:				
Numerator-net loss	\$ (868,000)	\$ (435,000)	\$ (3,511,000)	\$ (858,000)
Denominator-weighted average common shares outstanding	10,180,000	10,169,000	10,180,000	10,169,000
Diluted effect of common stock options	10,180,000	10,169,000	10,180,000	10,169,000
Diluted earnings (loss) per share	\$ (0.09)	\$ (0.04)	\$ (0.34)	\$ (0.08)

Options to purchase 872,000 shares of common stock at prices ranging from \$0.50 to \$7.62 per share and 914,000 shares of common stock at prices ranging from \$0.50 to \$11.50 were not included in the computation of diluted earnings per share for the three and nine-month periods ended December 31, 2007 and 2006, respectively, because their effect would have been anti-dilutive.

10. Income Tax Expense

Based on management's earnings projections for the fiscal year ended 2008, the Company has forecasted an effective tax rate of 35 percent. As of March 31, 2007, the Company has Federal net operating loss carryforwards of \$1,459,000 expiring in 2027 and California net operating loss carryforwards of \$3,442,000 expiring in 2013 through 2017. In assessing the realizability of deferred tax assets, management considered whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. At December 31, 2007, the Company's deferred tax assets are fully offset by a valuation allowance.

11. Geographic Information

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

---

**Table of Contents**

	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	2007	2006	2007	2006
United States	\$ 2,495,000	\$ 3,774,000	\$ 8,652,000	\$ 11,916,000
Canada	46,000	46,000	114,000	132,000
Japan	89,000	73,000	215,000	267,000
Europe	185,000	82,000	651,000	1,943,000
Indonesia		252,000	175,000	270,000
All other countries	114,000	80,000	301,000	238,000
	\$ 2,929,000	\$ 4,307,000	\$ 10,108,000	\$ 14,766,000

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

Sales of OXYMATIC®, LOTUS and CYPRESS OXYPneumatic® conservers and SAGE Therapeutic devices accounted for 64.4% and 64.9% of the Company's sales for the three-month periods ended December 31, 2007 and 2006, respectively and 66.3% and 69.6% of the Company's sales for the nine-month periods ended December 31, 2007 and 2006 respectively.

## 12. Stock Option Plan

On April 1, 2006, the Company adopted Statement of Financial Accounting Standards 123R, Share-Based Payment, which revised SFAS 123, Accounting for Stock-Based Compensation. The Company adopted FAS 123R using the modified prospective transition method. Previously, the Company had followed APB 25, accounting for employee stock options at intrinsic value. Accordingly, during the three and nine-month periods ended December 31, 2007 and 2006, the Company recorded stock-based compensation expense for awards granted prior to, but not yet vested, as of April 1, 2006, as if the fair value method required for pro forma disclosure under FAS 123 were in effect for expense recognition purposes, adjusted for estimated forfeitures. For stock-based awards granted after April 1, 2006, the Company would recognize compensation expense based on the estimated grant date fair value method using the Black-Scholes valuation model. For these awards, the Company would recognize compensation expense using a straight-line method. As FAS 123R requires that stock based compensation expense be based on awards that are ultimately expected to vest, stock-based compensation for the three and nine-month periods ended December 31, 2007 and 2006, has been reduced for estimated forfeitures. For the nine-month period ended December 31, 2007, stock-based compensation expense of \$8,000 was recorded to selling, general, and administrative expenses, all of which was due to FAS 123R option expense. For the nine-month period ended December 31, 2006, stock-based compensation expense of \$67,000 was recorded to selling, general, and administrative expenses. Of the \$67,000 in stock-based compensation recorded for the nine-month period ended December 31, 2006, \$27,000 related to FAS 123R option expense with the remaining \$40,000 related to restricted stock issued to directors that vested April 1, 2006. Due to the prospective adoption of SFAS No. 123R, results for prior period have not been restated.

The Company has an equity incentive plan (the Plan) for key employees as defined under Section 422(A) of the Internal Revenue Code. The Plan provides that 750,000

**Table of Contents**

common shares be reserved for issuance under the Plan, which expires on September 8, 2014, of which approximately 735,000 were available for future grant at December 31, 2007. In addition, the Plan provides that non-qualified options can be granted to directors and independent contractors of the Company. Stock options are granted with an exercise price equal to the market value of a share of the Company's stock on the date of the grant. Historically, grants to non-employee directors have vested over two years, while the majority of grants to employees have vested over two to five years of continuous service.

The fair value of each stock option award is estimated on the date of the grant using the Black-Scholes option valuation model. Expected volatility is based on the historical volatility of the Company's stock. No expected dividend yield is used since the Company has not historically declared or paid dividends and no dividends are expected in the foreseeable future. The risk-free interest rate is based on the U.S. treasury yield curve on the grant date for the expected term of the option. The Company did not grant any stock options during the nine months ended December 31, 2007 and 2006, respectively. A summary of stock option activity as of and for the nine-months ended December 31, 2007, is presented below:

	Shares	Exercise Price Per Share	Remaining Contractual Term (in years)
Outstanding at March 31, 2007	904,000	\$ 2.09	
Granted			
Exercised			
Forfeited or expired	32,000	1.52	
Outstanding at December 31, 2007	872,000	\$ 2.04	3.7
As of December 31, 2007:			
Exercisable	861,000	\$ 2.08	3.7
Vested and expected to vest	869,000	\$ 2.09	3.7

No options were granted or exercised during the nine-months ended December 31, 2007 or 2006.

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of the Company's common stock at December 31, 2007 for the options that were in-the-money at December 31, 2007. As of December 31, 2007, there was approximately \$2,000 of unrecognized compensation cost related to unvested stock-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of 6 months.

13. **Warrants**

In connection with the Convertible Note financing transaction that the Company entered into in July 2007, the Company issued warrants to purchase up to 976,744 shares of the Company's common stock at an exercise price of \$1.24 per share. The closing price of the Company's common stock on the issue date of the warrants was

**Table of Contents**

\$1.00 per share. The fair value of the warrants was approximately \$588,000 and was determined using a Black Scholes pricing model. These warrants expire ten years from the date of issue and have a lock-up period of 12 months after any warrants are exercised. The warrants will be amortized over the 36 month life of the Convertible Note.

For the nine months ended December 31, 2007, amortization of the warrants was \$98,000. There was no warrant amortization in fiscal year 2006.

14. **Commitments**

The Company is currently leasing its administrative and plant facilities and certain office equipment under noncancelable operating leases that expire in June 2008.

The Company has minimum annual royalty requirements pursuant to the terms of license agreements related to certain products in the amount of \$530,000. License agreements with minimum annual royalty requirements are in place through fiscal year 2016.

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

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

15. **Use of Estimates**

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

---

**Table of Contents**

16. Accounting Standards

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option of Financial Assets and Financial Liabilities. SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected by reported in earnings. SFAS No. 159 is effective as of the beginning of the entity's first fiscal year that begins after November 15, 2007. The Company is currently evaluating the impact that SFAS No. 159 will have on its financial statements.

---

**TABLE OF CONTENTS**

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

Item 3. Quantitative and Qualitative Disclosures about Market Risks

Item 4. Controls and Procedures

**Part II**

Item 1. Legal Proceedings

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

Item 3. Defaults Upon Senior Securities

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

Item 5. Other Information

Item 6. Exhibits

**SIGNATURE**

**INDEX TO EXHIBITS**

**EXHIBIT 31.1**

**EXHIBIT 31.2**

**EXHIBIT 32**

**EXHIBIT 99.1**

---

**Table of Contents**

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

Cautionary Statement

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

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

Overview

CHAD Therapeutics, Inc. (the "Company") develops, assembles, and markets medical devices that furnish supplementary oxygen to home health care patients. The Company was a pioneer in developing oxygen conserving devices that enhance the quality of life for patients by increasing their mobility and, at the same time, lower operating costs by achieving significant savings in the amount of oxygen actually required to properly oxygenate patients. The market for oxygen conserving devices has been, and continues to be, significantly affected by increased competition, consolidation among home oxygen dealers, and revisions (and proposed revisions) in governmental reimbursement policies. All of these factors, as described more fully below, have contributed to a more difficult market for the Company's products. These factors contributed to a significant decline in the Company's operating results for the six-month period ended December 31, 2007.

The procedures for reimbursement by Medicare for home oxygen services provide a prospective flat fee monthly payment based solely on the patient's prescribed oxygen requirement. Beginning January 1, 2006, the reimbursement procedures were modified to provide that title for the equipment being used by a patient transfers to the patient after 36 months. Under this system, inexpensive concentrators have grown in popularity because of low cost and less frequent servicing requirements. At the same time, oxygen conserving devices, such as the Company's products, have also grown in popularity due to their ability to extend the life of oxygen supplies and reduce service calls by dealers, thereby providing improved mobility for the patient and cost savings for dealers. However, the uncertainties created by the new reimbursement procedures have adversely

---

**Table of Contents**

affected the market for our products by causing many home health care dealers to delay product purchases as they seek to assess the impact of the new procedures and proposed revisions.

On January 1, 2007, rates that include a new reimbursement category for transfilling systems like the Company's TOTAL O2® Delivery System became effective. These new rates may ultimately have a positive impact on the market for these types of devices. However, in 2003 Congress enacted the Medicare Improvement and Modernization Act, which mandates that the monthly fees that homecare providers receive for servicing oxygen patients will be subject to competitive bidding. The process began in August 2007 but has been delayed until July 2008. Continuing concern among home care providers about the potential impact of these changes in reimbursement may affect demand for the Company's products.

In addition, other changes in the health care delivery system, including the increase in the acceptance and utilization of managed care, have stimulated a significant consolidation among home care providers. Major national and regional home medical equipment chains have continued to expand their distribution networks through the acquisition of independent dealers in strategic areas. Margins on sales to national chains are generally lower due to quantity pricing and management anticipates continued downward pressure on its average selling price. Four major national chains accounted for approximately 40% and 32% of the Company's net sales for the three-month period ended December 31, 2007 and 2006, respectively, and 47% of the Company's net sales for the nine-month periods ended December 31, 2007 and 2006, respectively. One chain accounted for 33% and 44% of net sales for the three-month periods ended December 31, 2007 and 2006, respectively, and 39% and 40% of net sales for the nine-month periods ended December 31, 2007 and 2006, respectively. This increased dependence on a limited number of large customers may result in greater volatility and unpredictability of future operating results as changes in the purchasing decisions by one or more major customers can have a material effect upon our financial statements.

The Company believes that price competition and continuing industry consolidation will continue to adversely affect the marketplace for oxygen therapy products for the foreseeable future. In light of the competitive and unpredictable nature of the oxygen conserver marketplace and the Company's limited financial resources, the Company elected to pursue the following strategy:

Exit the oxygen conserver market and focus the Company's resources on entering the sleep therapy market.

The Company has invested in the development of diagnostic and therapeutic devices for the high-growth sleep disorder market. The first of these products are currently undergoing testing and finalization of product design. While reports to date have been encouraging, the Company cannot predict at this time when it will commercially introduce such products, nor can it estimate the level of success it might achieve in selling products for the sleep market.

---

**Table of Contents**

On November 16, 2007, the Company entered into a definitive agreement, subject to shareholder approval, to sell to Inovo, Inc. (the Buyer) substantially all of the assets of the Company related to the oxygen conserver business including accounts receivable, inventory, and certain equipment and intellectual property (the Asset Sale) pursuant to an Asset Purchase Agreement (the APA). On January 31, 2008, the Company's shareholders approved the sale. The Asset Sale is scheduled to be completed on February 15, 2008. Pursuant to the APA, the Buyer would assume certain liabilities and obligations related to the Company's oxygen conserver business. Once the Asset Sale is completed, the Company will no longer develop and sell oxygen conserver products. The Company will retain the assets related to its TOTAL O2 and in-home transfilling business, as well as products in development for the sleep disorder market. The Company is seeking to sell its in-home transfilling business and intends to focus its future efforts on the sleep disorder market.

The selling price for the oxygen conserver assets is \$5,250,000 in cash, subject to adjustment for changes in working capital as defined in the APA between the execution date of the APA and closing date (the Selling Price). The Selling Price may not exceed \$5,500,000. There is no limit on the possible downward adjustment of the Selling Price based upon a decline in the Company's working capital as defined in the APA between November 16, 2007 and the closing date of the Asset Sale.

While management believes the Asset Sale should enable the Company to focus its efforts upon the growth opportunities presented by the sleep disorder market, none of the Company's sleep disorder products are commercially available. Accordingly, in the near term the Company would continue to incur product development and operating expenses while generating limited or no revenue from product sales. Revenues from the sale of in-home transfilling products was \$216,000 and \$669,000 for the three and nine month periods ended December 31, 2007; however, the Company is actively seeking to sell such business. The Company has not generated any revenues from the sales of its sleep disorder products and it cannot predict when, if ever, it will generate revenues from sales of such products. The products for the sleep disorder market may never gain market acceptance and the Company may never achieve sufficient levels of revenue or profitability necessary to become a viable participant in the sleep disorder market. The Company expects operating losses to continue through the foreseeable future as it continues to expend resources to complete development of its products, obtain regulatory clearances and approvals, conduct further research and development, and launch its products into the marketplace. For information that may affect the outcome of forward-looking statements in this Overview regarding the Company's business strategy and its introduction of new products, see Part II of this report, Item 1A Risk Factors.

**Results of Operations**

The Company's operating results deteriorated significantly during the three- and nine-month periods ended December 31, 2007. Net sales for the three and nine-month periods ended December 31, 2007 decreased by \$1,378,000 (32.0%) and \$4,658,000 (31.6%), respectively, as compared to the same periods in the prior year. The primary reasons for the decrease in sales for the three and nine-month periods ended December 31, 2007,

---

**Table of Contents**

were (i) a decline of 27.1% and 27.7%, respectively, in unit sales of conservers, (ii) price reductions on domestic conservers, (iii) decreases in TOTAL O2 sales and (iv) a decline in sales to foreign distributors. Revenues from conserver and therapeutic device sales decreased by 32.5% and 34.8%, respectively for the three and nine-month periods ended December 31, 2007 as compared to prior year. The Company believes that the reduction in unit sales is largely the result of continuing uncertainty regarding government reimbursement policies, which has caused many dealers to defer or reduce their purchases of new equipment. In addition, conserver sales to the Company's largest customer declined by approximately 49.5% and 32.5%, respectively, for the three and nine months ended December 31, 2007, as compared to the prior year's period as the Company has encountered increased competition in the sale of pneumatic conservers to such customer. As noted above, management expects continued downward pressure on its average selling price. In addition, future operating results may be increasingly dependent upon purchasing decisions of a limited number of large customers.

Revenues from TOTAL O2 sales decreased 59.5% and 53.8% for the three and nine-month periods ended December 31, 2007, as compared to the same period in the prior year. Ongoing concerns regarding potential additional changes to reimbursement procedures continue to negatively impact sales of the TOTAL O2 System. Sales to foreign distributors represented 14.9% and 12.4% and 14.4% and 19.3% of net sales for the three and nine-month periods ended December 31, 2007 and 2006, respectively. Foreign sales declined by 18.4% and 48.9% for the three and nine-month periods as compared to the same periods in the previous year. This decrease was driven by a 32.5% and a 34.8% decrease in conserver sales for the three and nine-month periods ended December 31, 2007, as compared to the same period in the prior year.

Cost of sales as a percent of net sales decreased from 75.4% to 60.4% for the three-month period ended December 31, 2007, and increased from 69.6% and 74.7% for the nine-month period ended December 31, 2007, as compared to the same periods in the prior year. The decrease in cost of sales as a percentage of sales for the three-month period as compared to the same period in the prior year is due to a decrease in employees as well as a decrease in employee benefits. The increase in cost of sales as a percentage of net sales for the nine-month period as compared to the same period in the prior years was primarily due to the decrease in sales as compared to consistent fixed manufacturing costs, as well as continued downward price pressures in the marketplace and an increase in sales as a percentage of total sales to high volume purchasers that receive discounted rates. We currently expect downward price pressure for the foreseeable future. While the Company has sought to reduce manufacturing costs by transferring some operations to overseas contractors, such efforts have not yet produced significant cost savings, largely as a result of quality and reliability issues encountered in qualifying such overseas contractors.

Selling, general, and administrative expenditures increased from 33.0% to 52.5% and from 32.5% to 44.5%, respectively, as a percentage of net sales for the three and nine-month periods ended December 31, 2007, as compared to the same periods in the prior year. While the Company's ongoing cost reduction efforts have decreased actual selling, general, and administration expenditures, decreases in sales revenues have resulted in selling, general, and administrative costs increasing as a percentage of net sales. Research

---

**Table of Contents**

and development expenses decreased by \$37,000 and increased by \$159,000, respectively for the three and nine-month periods ended December 31, 2007, as compared to the same periods in the prior year. Currently management expects research and development expenditures to total approximately \$1,754,000 in the fiscal year ending March 31, 2008, on projects to enhance and expand the Company's sleep product line. During fiscal year 2007, the Company spent \$1,466,000 on research and development. The Company wrote down a \$48,000 license fee during the second quarter of fiscal year 2008 when the Company determined to stop development of the product lines related to that license fee.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. As of March 31, 2007, the Company has Federal net operating loss carryforwards of \$1,459,000 expiring in 2027 and California net operating loss carryforwards of \$3,442,000 expiring in 2010 through 2013. At December 31, 2007, the Company has fully reserved against all of its Federal and State net operating loss carryforwards. The Company will continue to assess the valuation allowance and to the extent it is determined that such allowance is no longer required, the tax benefit of the remaining net deferred tax assets may be recognized in the future.

Financial Condition

General

The significant deterioration in the Company's operating results during the six-months ended December 31, 2007 has contributed to a worsening of the Company's financial condition. During that period, the Company's negative cash flow from operations was approximately \$1,771,000, with \$1,702,000 of negative cash flow resulting from operations between July 1 and December 31, 2007. The cash raised by the Company through its borrowings from Calliope Capital Corporation (discussed below) has largely been exhausted to fund on-going operations in light of the decline in operating results.

In order to address this situation, on November 16, 2007, the Company entered into a definitive agreement, subject to shareholder approval, to sell to Inovo, Inc. (the "Buyer") substantially all of the assets of the Company related to the oxygen conserver business including accounts receivable, inventory, and certain equipment and intellectual property (the "Asset Sale") pursuant to an Asset Purchase Agreement (the "APA"). The Asset Sale was approved by a majority of the Company's shareholders on January 31, 2008, and is scheduled to close on February 15, 2008. Pursuant to the APA, the Buyer would assume certain liabilities and obligations related to the Company's oxygen conserver business. Once the Asset Sale is completed, the Company will no longer develop and sell oxygen conserver products. The Company will retain the assets related to its TOTAL O2 and in-home transfilling business, as well as products in development for the sleep disorder market. The Company is seeking to sell its in-home transfilling business and intends to focus its future efforts on the sleep disorder market.

The selling price for the conserver assets is \$5,250,000, subject to adjustment for changes in working capital as defined in the APA between the execution date of the APA and closing date (the "Selling Price"). The Selling Price may not exceed \$5,500,000. There

---

**Table of Contents**

is no limit on the potential downward adjustment of the Selling Price based upon a decline in the Company's working capital as defined in the APA.

If the Asset Sale closes during the first calendar quarter, then the Company anticipates it will have sufficient working capital in place for the next 12 months to continue operations. If the Asset Sale is not completed during the first calendar quarter of 2008, then the Company would require additional capital resources which may only be available pursuant to terms and conditions that would result in significant cost to the Company and significant dilution of the shareholders' interest in the Company and its assets. Moreover, such additional financing may not be available at all, in which event the Company would need to consider other alternatives, including an orderly liquidation of its assets, curtailment of its current operations and seeking protection under the federal bankruptcy laws.

At December 31, 2007, the Company had cash totaling \$261,000 or 2.6% of total assets, as compared to \$375,000 (3.2% of total assets) at March 31, 2007. Net working capital decreased from \$7,266,000 at March 31, 2007, to \$4,135,000 at December 31, 2007. Net accounts receivable decreased \$906,000 during the six months ended December 31, 2007, due to the decrease in sales and the timing of payments from significant customers. Future increases or decreases in accounts receivable will generally coincide with sales volume fluctuations and the timing of shipments to foreign customers. During the same period, inventories decreased \$417,000. The Company attempts to maintain sufficient inventories to meet its customer needs as orders are received and new products are introduced. Thus, future inventory and related accounts payable levels will be impacted by the ability of the Company to maintain its safety stock levels. If safety stock levels drop to target amounts, then inventories in subsequent periods will increase more rapidly as inventory balances are replenished.

**Liquidity and Capital Resources**

Historically, the Company has depended primarily upon its cash flow from operations to finance its inventory and operating expenses and to meet its capital requirements. However, recent operating trends have required the Company to seek outside financing in order to enhance its cash resources. The Company's cash flow for the nine-months ended December 31, 2007, was negative and the Company cannot predict when it will generate a positive cash flow from operations. The Company anticipates capital expenditures during the next twelve months to be approximately \$100,000. Moreover, the Company's efforts to expand its product line and enter the sleep disorder market may require significant cash resources for product development, manufacturing, and marketing.

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

On July 30, 2007, the Company entered into a financing transaction with Calliope Capital Corporation, a Delaware corporation (the "Investor") pursuant to which the Company

---

**Table of Contents**

issued to the Investor a \$750,000 convertible term note ( Convertible Note ) and a \$2,750,000 revolving credit line ( Credit Line ), all secured by the Company s assets. The Convertible Note is payable in equal installments over 36 months and bears interest at prime plus 2%, and the Credit Line bears interest at prime plus 1.5%. A portion of the financing was used to pay all outstanding obligations on the Company s factoring arrangement. Total borrowings against the line of credit were \$1,168,000 at December 31, 2007 while total borrowings against the Convertible Note were \$682,000.

At the Investor s option, the Convertible Note may be converted into shares of the Company s common stock any time during the term of the note at a conversion price of \$1.18. In addition, warrants to purchase up to 976,744 shares of the Company s common stock were issued to the Investor with an exercise price of \$1.24 per share. The Investor was granted registration rights with respect to the shares underlying the warrants. The warrants include a lock-up feature for a period of 12 months after any warrants are exercised.

The Company is not in a position to make substantial additional draws on the Calliope Captial Credit Line. In order to address the Company s limited ability to draw against its Credit Line, on January 2, 2008, we entered a Subordinated Secured Note and Warrant Purchase Agreement (the Credit Facility ) with Mr. Earl Yager and Mr. Thomas Jones, our Chief Executive Officer and our Chairman of the Board, respectively. The Company entered into the financing arrangement after it was unsuccessful in obtaining financing on acceptable terms from a third party. The terms of the financing arrangement were negotiated and approved by the Company s independent directors who concluded that the terms were more favorable to the Company than those available from third party lenders. Pursuant to the terms of the Credit Facility, the Company may draw an aggregate of \$1,000,000, subject to certain conditions. As of February 12, 2008, the Company had borrowed \$550,000 under this facility.

Notes issued under the Credit Facility bear interest at a rate of 8% per annum and will mature at the earlier of (i) two business days after the closing of the APA with Inovo or (ii) August 30, 2010. The notes are secured by a lien on the assets of the Company that is subordinated to the security interest of Calliope Capital Corporation.

In connection with the Credit Facility, Mr. Yager and Mr. Jones each received 321,428 warrants to purchase our common stock at a price per share equal to \$.28 (the average closing price of our common stock on the American Stock Exchange for the five days immediately preceding the initial funding under the Credit Facility). The warrants have a term of five years. No additional warrants are issuable in connection with any additional borrowings the Company may make under the Credit Facility.

The following table aggregates all of the Company s material contractual obligations as of December 31, 2007. This table does not reflect the obligations incurred under the Credit Facility in January 2008:

---

**Table of Contents**

## Payments Due by Period

Contractual Obligations	Total	Less than 1 Year	1 3 Years	3 5 Years	After 5 Years
Operating lease obligations	\$ 246,000	\$237,000	\$ 9,000		
Minimum royalty obligations	\$1,627,000	\$530,000	\$1,007,000	\$ 90,000	
Employee obligations	\$ 160,000	\$160,000			
Convertible Note	\$ 682,000	\$250,000	\$ 250,000	\$182,000	

Operating lease commitments consist primarily of a real property lease for the Company's corporate office, as well as minor equipment leases. Payments for these lease commitments have been provided for by cash flows generated from operations. Please see Note 8 to the financial statements in the 2007 Annual Report.

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

The Company has not adopted any programs that provide for post-employment retirement benefits; however, it has on occasion provided such benefits to individual employees. The Company does not have any off-balance sheet arrangements with any special purpose entities or any other parties, does not enter into any transactions in derivatives, and has no material transactions with any related parties.

**Critical Accounting Policies**

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

**Table of Contents**

following discussion addresses the accounting policies and estimates that are most important in the portrayal of the Company's financial condition and results.

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

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

**Intangible and long-lived assets** – The Company's intangible assets consist of license fees and the costs associated with obtaining patents including legal and filing fees. At December 31, 2007, approximately \$944,000 of these intangible assets relate to products under development for the sleep disorder market, with the balance relating to the Company's oxygen therapy products. The Company uses actual costs when recording the fair value of these intangible assets. If there is a triggering event, the Company assesses whether or not there has been an impairment of intangible and long-lived assets in evaluating the carrying value of these assets. Assets are considered impaired if the carrying value is not recoverable over the useful life of the asset. If an asset is considered impaired, the amount by which the carrying value exceeds the fair value of the asset is written off. In assessing the carrying amounts of the assets related to the sleep disorder market, the Company has considered the size of the market and potential future cash flows for these products based on statistics available through the National Institute of Health and Medicare, as well as data from other professional sources. In assessing the carrying amounts of the assets related to the oxygen therapy market, the Company considered two separate events as triggering events. In August 2007, the Company discontinued development of a product line resulting in the write-off of \$48,000 in license fees relating to the product line no longer in development. The Company also considered the Asset Sale an indicator of fair value for the intangible assets relating to the oxygen therapy market remaining at December 31, 2007 resulting in no change to the net book value of those assets. The Company bases the useful life of its intangible assets on the assets patent life, currently 17 years. The Company utilizes patent life as its useful life due to its product history. The Company's experience has been that technology supported by the patents the Company has established is utilized for the entire life of the patent. The likelihood of a material change in the Company's reported results is dependent on each asset's ability to continue to generate income, loss of legal ownership or title to an asset, and the impact of significant negative industry or economic trends.

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

---

**Table of Contents**

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

**Recently Issued Accounting Standards**

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

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option of Financial Assets and Financial Liabilities. SFAS No. 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected by reported in earnings. SFAS No. 159 is effective as of the beginning of the entity's first fiscal year that begins after November 15, 2007. The Company is currently evaluating the impact that SFAS No. 159 will have on its financial statements.

**Item 3. Quantitative and Qualitative Disclosures about Market Risks**

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

**Item 4. Controls and Procedures**

The Company has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of December 31, 2007 (the Evaluation Date). Such evaluation was conducted under the supervision and with the participation of the Company's Chief Executive Officer (CEO) and its Chief Financial Officer (CFO). Based upon such evaluation, the Company's CEO and CFO have concluded that, as of the Evaluation Date, the Company's disclosure controls and procedures were effective to ensure that the Company record, process, summarize, and report information required to be disclosed by the Company in its quarterly reports filed under Securities Exchange Act within the time periods specified by the Securities and Exchange Commission's rules and forms and accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. There have been no significant changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Part II**

**Other Information**

**Item 1. Legal Proceedings**

None.

---

**Table of Contents**

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds  
None.

Item 3. Defaults Upon Senior Securities  
Not applicable.

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

The Company held a Special Meeting of Shareholders on January 31, 2008:

- (a) The Company's Special Meeting of Shareholders was held on January 31, 2008 in Chatsworth, California.
- (b) Proxies for the meeting were solicited pursuant to Regulation 14A under the Securities Exchange Act of 1934..
- (c) At the Special Meeting, the following matters were considered and voted upon:
  - (i) The approval of the sale of the Company's oxygen conserver business in accordance with the terms and conditions of an Asset Purchase Agreement, dated as of November 16, 2007, between Inovo, Inc., a Florida corporation, and CHAD Therapeutics, Inc., a California corporation

	For	Against	Withheld
To approve the Asset Sale	7,183,378	49,300	8,807

Item 5. Other Information  
None.

Item 6. Exhibits

10.5 Pulser System License Agreement, as amended, with Robert E. Phillips, Brian L. Tiep, M.D., and Ben A. Otsap. (The Pulser System is now called the OXYMATIC.) <sup>(1)</sup>

10.20 OXYCOIL tubing License Agreement with Mary Smart (licensed under the name Respi-Coil). <sup>(2)</sup>

(1) Previously filed as an Exhibit to the Registrant's Registration Statement on Form S-18, File No. 2-83926.

(2) Previously filed as an Exhibit to the Registrant's Annual Report on Form 10-K for the year ended March 31, 1986.

(3) Previously filed as an Exhibit to the Registrant's Annual Report on Form 10-K for the year ended March 31, 1993.

- (4) Previously filed as an exhibit to the Registrant's Annual Report on Form 10-K for the year ended March 31, 1996.
  - (5) Previously filed as an exhibit to the Registrant's Annual Report on Form 10-K for the year ended March 31, 1998.
  - (6) Previously filed as Appendix A of the Registrant's Proxy Statement for the 2004 Annual Shareholders Meeting.
  - (7) Previously filed as an Exhibit to the Registrant's Form 8-K dated August 3, 2007.
  - (8) Previously filed as an Exhibit to the Registrants Report on Form 10-Q for the quarter ended September 30, 2007.
-

**Table of Contents**

10.23 Summary plan description for CHAD Therapeutics, Inc. Employee Savings and Retirement Plan <sup>(3)</sup>  
10.24 1994 Stock Option Plan <sup>(4)</sup>  
10.25 Lease on real property at 21622 Plummer Street, Chatsworth, California <sup>(4)</sup>  
10.26 TOTAL O2 Delivery System License Agreement, as amended, with the Carleton Life Support Division of Litton Industries, Inc. <sup>(5)</sup>  
10.27 2004 Equity Incentive Plan <sup>(6)</sup>  
10.28 Security Agreement dated July 30, 2007 <sup>(7)</sup>  
10.29 Registration Rights Agreement dated July 30, 2007 <sup>(7)</sup>  
10.30 Secured Convertible Term Note dated July 30, 2007 <sup>(7)</sup>  
10.31 Secured Revolving Note dated July 30, 2007 <sup>(7)</sup>  
10.32 Warrant dated July 30, 2007 <sup>(7)</sup>  
10.33 Asset Purchase Agreement dated November 16, 2007<sup>(8)</sup>  
31.1 Certification pursuant to Section 302 of Sarbanes-Oxley Act of 2002 for CEO  
31.2 Certification pursuant to Section 302 of Sarbanes-Oxley Act of 2002 for CFO  
32\* Certification pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002  
99.1 Press release dated February 14, 2008

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

foregoing  
information into  
those documents  
by reference.

---

**Table of Contents**

SIGNATURE

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

CHAD THERAPEUTICS, Inc.  
(Registrant)

Date 02/14/2008

/s/ Earl L. Yager

Earl L. Yager  
President and Chief Executive Officer

Date 02/14/2008

/s/ Tracy A. Kern

Tracy A. Kern  
Chief Financial Officer

---

**Table of Contents**

INDEX TO EXHIBITS

Exhibit No.	Description of Exhibits
31.1	Certification pursuant to Section 302 of Sarbanes-Oxley Act of 2002 for CEO
31.2	Certification pursuant to Section 302 of Sarbanes-Oxley Act of 2002 for CFO
32*	Certification pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002
99.1	Press release dated February 14, 2008

\* The information in Exhibit 32 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act ) or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this quarterly report), unless CHAD Therapeutics specifically incorporates the foregoing information into those documents by reference.