

ARRHYTHMIA RESEARCH TECHNOLOGY INC /DE/  
Form 10-Q  
August 15, 2011

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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 the quarterly period ended June 30, 2011 or

Transition report under Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

001-9731  
(Commission file No.)

ARRHYTHMIA RESEARCH TECHNOLOGY, INC.  
(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of incorporation or organization)

72-0925679  
(I.R.S. employer identification no.)

25 Sawyer Passway  
Fitchburg, Massachusetts 01420  
(Address of principal executive offices)

(978) 345-5000  
(Issuer's telephone number, including area code)

Check whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 has submitted electronically and posted on its corporate Web site, if any every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and

post such files). 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 [  ]

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

As of August 7, 2011 there were 2,790,514 shares of the Company’s common stock outstanding.

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## PART I - FINANCIAL INFORMATION

## Item 1. Consolidated Financial Statements

## ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

ASSETS	June 30, 2011	December 31, 2010
Current assets:	(Unaudited)	(Audited)
Cash and cash equivalents	\$3,561,581	\$3,962,454
Trade and other accounts receivable, net of allowance for doubtful accounts of \$29,298 and \$83,976	3,918,945	3,819,361
Inventories, net	2,503,519	3,069,177
Deferred income taxes, net	355,000	44,000
Prepaid tax	49,194	166,694
Deposits, prepaid expenses and other current assets	356,258	397,010
Total current assets	10,744,497	11,458,696
Property and equipment, net of accumulated depreciation of \$9,696,226 and \$9,101,732	6,720,534	6,691,817
Goodwill	1,564,966	1,564,966
Other intangible assets, net	120,612	96,446
Restricted cash	—	517,571
Total assets	\$19,150,609	\$20,329,496
 <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$1,179,937	\$2,280,992
Accrued expenses	451,727	275,197
Total current liabilities	1,631,664	2,556,189
Long term liabilities:		
Long term deferred tax liability, net	387,965	330,000
Long term portion of deferred gain on lease	15,634	17,868
Total long term liabilities	403,599	347,868
Total liabilities	2,035,263	2,904,057
Shareholders' equity:		
Preferred stock, \$1 par value; 2,000,000 shares authorized, none issued	—	—
Common stock, \$0.01 par value; 10,000,000 shares authorized, 3,926,491 shares issued, 2,790,514 outstanding	39,265	39,265
Additional paid-in-capital	10,715,074	10,653,210
Common stock held in treasury, 1,135,977 shares at cost	(3,099,842 )	(3,099,842 )

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Accumulated other comprehensive income from foreign currency translation	66,192	42,502
Retained earnings	9,394,657	9,790,304
Total shareholders' equity	17,115,346	17,425,439
Total liabilities and shareholders' equity	\$ 19,150,609	\$ 20,329,496

The accompanying notes are an integral part of the consolidated financial statements.

## ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARIES

## Consolidated Statements of Operations

(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2011	2010	2011	2010
Revenue	\$6,018,329	\$5,782,279	\$12,201,394	\$11,367,639
Cost of sales	4,994,063	4,687,802	9,798,842	9,289,014
Gross profit	1,024,266	1,094,477	2,402,552	2,078,625
Selling and marketing	413,517	255,637	773,530	413,626
General and administrative	920,473	671,862	1,798,843	1,275,859
Research and development	106,656	47,138	187,864	102,811
Total expense	1,440,646	974,637	2,760,237	1,792,296
Income (loss) from operations	(416,380)	) 119,840	(357,685)	) 286,329
Other income (expense), net	5,351	144,647	(5,211)	) 144,769
Income (loss) before income taxes	(411,029)	) 264,487	(362,896)	) 431,098
Income tax provision (benefit)	(156,485)	) 45,800	(135,485)	) 109,800
Net income (loss)	\$(254,544)	) \$218,687	\$(227,411)	) \$321,298
Net income (loss) per share – basic	\$(0.09)	) \$0.08	\$(0.08)	) \$0.12
Net income (loss) per share – diluted	\$(0.09)	) \$0.08	\$(0.08)	) \$0.12
Weighted average common shares				
Outstanding – basic	2,790,514	2,691,914	2,790,514	2,683,743
Weighted average common shares				
Outstanding – diluted	N/A	2,739,858	N/A	2,731,687

The accompanying notes are an integral part of the consolidated financial statements.

## ARRHYTHMIA RESEARCH TECHNOLOGIES, INC. AND SUBSIDIARIES

## Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income (Loss)

(Unaudited)

	Common Stock		Additional paid-in capital	Treasury stock	Accumulated other comprehensive income	Retained earnings	Total	Comprehensive income (loss)
	Shares	Amount						
December 31, 2010	3,926,491	\$39,265	\$10,653,210	\$(3,099,842)	\$42,502	\$9,790,304	\$17,425,439	
Foreign currency translation adjustments					23,690		23,690	\$23,690
Share based compensation			61,864				61,864	—
Cash dividends						(168,236)	(168,236)	—
Net loss						(227,411)	(227,411)	(227,411)
Comprehensive loss								\$(203,721)
June 30, 2011	3,926,491	\$39,265	\$10,715,074	\$(3,099,842)	\$66,192	\$9,394,657	\$17,115,346	

See accompanying notes to consolidated financial statements.

## ARRHYTHMIA RESEARCH TECHNOLOGY, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

(Unaudited)

	Six months ended June 30,	
	2011	2010
Cash flows from operating activities:		
Net income (loss)	\$ (227,411	) \$ 321,298
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Non-cash gain from bargain purchase	—	(146,288 )
Depreciation and amortization	766,032	698,440
Share based compensation	61,864	57,011
Provision for doubtful accounts	(54,678	) 30,000
Deferred tax expense	(253,035	) (48,200 )
Changes in operating assets and liabilities:		
Trade and other accounts receivable	(44,906	) (499,409 )
Inventories	565,658	(50,142 )
Deposits, prepaid expenses and other assets	637,890	(184,891 )
Accounts payable and accrued expenses	(926,759	) (27,286 )
Net cash provided by operating activities	524,655	150,533
Cash flows from investing activities:		
Capital expenditures, net of disposals	(780,982	) (840,869 )
Acquisitions	—	16,357
Net cash used in investing activities	(780,982	) (824,512 )
Cash flows from financing activities:		
Cash dividend paid	(168,236	) (161,328 )
Net cash used in financing activities	(168,236	) (161,328 )
Effect of currency translation on cash and cash equivalents	23,690	—
Net decrease in cash and cash equivalents	(400,873	) (835,307 )
Cash and cash equivalents at beginning of period	3,962,454	3,674,179
Cash and cash equivalents at end of period	\$ 3,561,581	\$ 2,838,872

The accompanying notes are an integral part of the consolidated financial statements.



## Notes to the Consolidated Financial Statements

## 1. Basis of Presentation:

The unaudited interim consolidated financial statements and related notes have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in complete financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations. The accompanying unaudited interim consolidated financial statements and related notes should be read in conjunction with the consolidated financial statements and notes thereto included in the Arrhythmia Research Technology, Inc. and subsidiaries (the “Company”) Annual Report on Form 10-K for the year ended December 31, 2010 filed March 23, 2011.

The information presented reflects, in the opinion of the management of the Company, all adjustments necessary for a fair presentation of the financial results for the interim period presented.

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 and liabilities and disclosure 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 from those estimates. Operating results for interim periods are not necessarily indicative of results that may be expected for the entire fiscal year.

## 2. Inventories:

Inventories consist of the following as of:	June 30, 2011	December 31, 2010
Raw materials	\$ 675,362	\$ 911,440
Work-in-process	224,436	169,063
Finished goods	1,603,721	1,988,674
Total	\$ 2,503,519	\$ 3,069,177

The value of silver in inventory at June 30, 2011 as a part of finished goods as plated sensors, work in process, or raw material is \$746,368. Inventories are stated net of a reserve for slow moving or obsolete inventory.

## 3. Share-Based Compensation:

The Company accounts for non-cash share based compensation under ASC 718 “Stock Compensation”, which establishes accounting for equity instruments exchanged for employee services. Under the provisions of ASC 718, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee’s requisite service period (generally the vesting period of the equity grant).

The Company estimates the fair value of stock options using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price of the award, the expected option term, the expected volatility of the Company’s stock over the option’s expected term, the risk-free interest rate over the option’s expected term, and the Company’s expected annual dividend yield. The Company believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of the Company’s stock options. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by persons who receive equity awards.

The Company recognized share-based compensation expense of \$24,629 and \$20,115 for the three months ended June 30, 2011 and 2010, and \$61,864 and \$57,011 for the six months ended June 30, 2011 and 2010, respectively. Two grants totaling 160,000 options to 9 persons, including directors and management, were made during the three months ended June 30, 2011. Grants totaling 135,500 were made in the first six months of 2010 of which, 60,000 non-qualified options were outside of the Company's stock option plan in conjunction with business combination activities, of which 20,000 are currently exercisable.

The following is a weighted average of the assumptions used to estimate the fair market value of options granted using the Black Scholes valuation method:

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Dividend Yield	2.1%	0.47%
Expected Volatility	31.24%	36.92%
Risk Free Interest Rate	0.98%	1.3%
Expected Option Terms (in years)	5	4.5

#### Share-based Incentive Plan

At June 30, 2011, the Company has one stock option plan that includes both incentive stock options and non-qualified stock options to be granted to certain eligible employees, non-employee directors, or consultants of the Company. The maximum number of shares reserved for issuance is 500,000 shares. The options granted have six or ten year contractual terms and either vest immediately or vest annually over a five-year term.

The following table presents the average price and contractual life information about options outstanding and exercisable at June 30, 2011:

Exercise Price	Number of Outstanding Shares	Weighted Average Remaining Contractual Life (years)	Options Currently Exercisable	Average Fair Value at Grant Date
\$3.41	75,500	4.51	15,100	\$0.96
4.76	60,000	3.96	20,000	1.77
5.73	90,000	9.93	—	1.30
7.15	96,000	2.51	57,600	2.74
9.86	63,000	0.47	63,000	4.22
9.86	70,000	9.89	—	0.50
12.42	10,000	1.10	8,000	5.38
23.10	10,000	1.68	8,000	10.77
	474,500		171,700	

The aggregated intrinsic value of options outstanding and vested at June 30, 2011 was \$48,320 and \$9,664, respectively. The Company expects 240,938 or 79.6% of the 302,800 options to vest over their remaining life.

The following table summarizes the status of the Company's non-vested options since December 31, 2010:

	Non-Vested Options	
	Number of Shares	Weighted Average Fair Value
Non-vested at December 31, 2010	184,100	\$1.98
Granted	160,000	0.95
Vested	(41,300)	2.15
Forfeited	—	
Non-vested at June 30, 2011	302,800	\$1.41

At June 30, 2011, there was \$285,507 of total unrecognized cost related to non-vested share-based compensation arrangements granted under the Plan. This cost is expected to be recognized over a weighted average period of 1.52

years.

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#### 4. Income Taxes:

The Company accounts for income taxes in accordance with ASC 740 "Income Taxes," which requires recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities using tax rates in effect for the year in which the differences are expected to reverse.

The Company files income tax returns in the U.S. Federal jurisdiction and various state jurisdictions. The periods from 2007 to 2010 remain open to examination by the IRS and state jurisdictions. The Company believes it is not subject to any significant tax risks related to uncertain tax positions. The Company does not have any accrued interest or penalties associated with any unrecognized tax benefits, nor were any interest expenses recognized during the six months ended June 30, 2011 and 2010.

#### 5. Earnings per share:

In accordance with ASC 260, the basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding. Diluted earnings per share is computed similar to basic earnings per share except that the denominator is increased to include the number of additional shares that would have been outstanding if the potential shares had been issued and if the additional shares were dilutive. At June 30, 2011, 399,000 stock options were anti-dilutive and excluded in the earnings per share computation.

#### 6. RMDDx Acquisition:

On June 18, 2010, the Company, through a newly created Delaware subsidiary named RMDDxUSA Corp., purchased all of the outstanding shares of RMDDx Corporation ("RMDDx"), a Prince Edward Island corporation. The shares were exchanged for 115,033 shares of ART common stock and options to purchase 60,000 shares at \$4.76. These shares and options were immediately placed in escrow and are released and vested based upon the achievement of certain performance targets. The performance targets require client contracts, service volumes and gross sales with minimum gross margins. The first target was met during the third quarter of 2010.

RMDDxUSA Corp. is the U.S. sales and distribution operations entity for, and parent of, RMDDx.

RMDDx is a medical device and diagnostic service company dedicated to the development and commercialization of medical devices, medical information technology, medical diagnostics and patient monitoring through wireless, internet and telecommunication technologies. Since inception, the efforts have been devoted to the development of remote wireless medical technology for heart monitors.

The fair value of the assets acquired and liabilities assumed in the acquisition on June 18, 2010 is as follows:

Assets	
Current Assets	\$17,357
Fixed Assets	83,381
Deferred Tax Assets	165,872
Other Assets	512,483
Total Assets	\$779,093
Liabilities	
Current Liabilities	\$82,254
Total Liabilities	\$82,254

RMDDx has a deferred tax asset related to losses prior to the close of the transaction. The deferred tax asset is for Canadian and Provincial corporate income taxes. A valuation allowance of 20% was applied to the tax asset based on

projected ability to utilize the tax benefit in the time allowed. If in the future this valuation allowance is reduced, the tax expense of RMDDx will be reduced for that period.

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RMDDx had \$510,833 in cash which was restricted as it collateralized a guarantee on a stand-by letter of credit related to a Canadian Federal contracting economic incentive program involving an unrelated third party. The restriction was lifted during the second quarter of 2011 when the Company secured a \$1,000,000 letter of credit to replace the guarantee by the Province of Prince Edward Island. Using the judgment of management in the fair market valuation required by ASC 805 "Business Combinations", over the next 5 years the targets of the incentive program are expected to be achieved. These calculations and the associated assumptions are the basis for not including a contingent liability related to the guarantee on the Balance Sheet. The Province of Prince Edward Island (the Province), through an economic incentive program, has committed expense reimbursements up to \$585,000 to the company in the form of a labor and equipment rebate. An equipment rebate of \$100,000 was collected from the Province during the quarter ended June 30, 2011.

The common stock was issued from treasury, and the options were issued outside of the Company's existing stock option plan. The fair value of the options was determined by using the Black Scholes valuation methods described in Note 3. The fair value of the equity issued was determined based on the probability of the management of RMDDx meeting the performance targets required for the release and vesting of shares and options. In compliance with ASC 805-30-30-1, a fair value of the equity was determined to be \$550,551 and was calculated by discounting the targets outside of a 12 month period with an estimate of the probability of attainment. The determination of probabilities was made using the same assumptions used throughout the purchase accounting.

In compliance with 805-30-25-2, this transaction was deemed a "bargain purchase" with the resulting gain of \$146,288 booked as other income in the quarter ended June 30, 2010. This increase to other income offsets the general and administrative costs related to the transaction of approximately \$80,000. As defined by FASB ASC 805-30-25, the purchase of RMDDx was not a forced sale in which the seller acted under compulsion. The discount to fair value relates to the sellers belief in the future value of the combined entity exceeding the current value of the consideration

#### 7. Recent Pronouncements

Accounting Standards Update (ASU) 2011-05, "Comprehensive Income", revise the manner in which companies present comprehensive income in their financial statements. This ASU requires companies to report the components of comprehensive income in either a continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement would present the components of net income, similar to the Company's current Consolidated Statements of Operations, while the second statement would include the components of other comprehensive income (OCI), as well as a cumulative total for comprehensive income. This ASU does not change the items that must be reported in OCI. ASU 2011-05 must be applied retrospectively and is effective for the first quarter of 2012. Management is in the process of evaluating the presentation options required by this ASU.

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

### Forward-Looking Statements

Any forward looking statements made herein are based on current expectations of the Company that involve a number of risks and uncertainties and should not be considered as guarantees of future performance. These statements are made under the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. Forward looking statements may be identified by the use of words such as "expect," "anticipate," "believe," "intend," "plans," "predict," or "will". Although the Company believes that our expectations are based on reasonable assumptions, we can give no assurance that our expectations will materialize. Many factors could cause actual results to differ materially from our forward looking statements. Several of these factors include, without limitation: our ability to maintain our current pricing model and/or decrease our cost of sales; our ability to increase sales of higher margin products and services; variations in the mix of products and services sold; variability of customer delivery requirements; ability to license our software, provide timely customization and updates; a stable interest rate market and/or a stable currency rate environment in the world, and specifically the countries where we are doing business; continued availability of supplies or materials used in manufacturing at competitive prices; volatility in commodity and energy prices and our

ability to offset higher costs with price increases; adverse regulatory developments in the U.S. or any other country the Company plans to do business in; entrance of competitive products and services in the Company's markets; the ability of management to execute plans and motivate personnel in the execution of those plans; no adverse publicity related to the Company and/or its products; adverse claims relating to the Company's intellectual property; adoption of new, or changes in, accounting principles; passage of new, or changes in, regulations; legal proceedings; ability to maintain compliance with the NYSE Amex requirements for continued listing of our common stock; the costs inherent with complying with statutes and regulations applicable to public reporting companies, such as the Sarbanes-Oxley Act of 2002; our ability to efficiently integrate acquisitions and other new lines of business that the Company may enter in the future, if any; and other risks referenced from time to time elsewhere in this report and in our filings with the SEC.



The Company is under no obligation and does not intend to update, revise or otherwise publicly release any revisions to these forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of any unanticipated events. More information about factors that potentially could affect the Company's financial results is included in the Company's filings with the Securities and Exchange Commission, including its Annual Report on Form 10-K for the year ended December 31, 2010.

## Overview

Arrhythmia Research Technology, Inc. ("ART") is engaged in the licensing of medical software, which acquires data and analyzes electrical impulses of the heart to aid in the detection of potentially lethal arrhythmias. Micron Products, Inc. ("Micron"), a wholly owned subsidiary, is the primary source of consolidated revenues. This primary source of revenue relates to the manufacturing of components, devices and equipment primarily for the medical and defense industries. The single largest category of revenue relates to Micron's production and sale of silver/silver chloride coated and conductive resin sensors used as component parts in the manufacture of integrated disposable electrophysiological sensors. These disposable medical devices are used worldwide in the monitoring of electrical signals in various medical applications. In an effort to leverage these skills, the Company has expanded into custom thermoplastic injection molded products with a full array of design, engineering and production services and management. With the addition of a medical machining cell, the Company began production of patient specific metal and plastic orthopedic devices. ART and its wholly-owned subsidiary, RMDDxUSA Corp. together with its subsidiary RMDDx Corporation (collectively, "WirelessDx") provide medical software and services, respectively, to the medical industry. While not currently adding significant revenue to the results, management believes these businesses have significant potential for future growth of the Company. Management continues to identify complementary and/or synergistic products, technologies and lines of business in an effort to broaden the Company's offerings.

## Results of Operations

Revenue for the three months ended June 30, 2011 was \$6,018,329 versus \$5,782,279 for the three months ended June 30, 2010, an increase of \$236,050 or 4%. Micron's medical sensors and snaps with silver surcharge revenue increased by \$1,007,000 and high volume precision molded products and other miscellaneous sales increased by \$88,000. The change in revenues from sensors and snaps is due to higher silver surcharge and per unit revenue from changes in product mix. Revenue from the Micron Integrated Technology's (MIT) product life cycle management programs decreased \$824,000 due to decreased volume from the Company's defense industry customers and the planned completion of a significant program. The MIT division's revenue is derived from the custom molding, precision metal machining and mold making activities. Combined revenues from ART's software and WirelessDx services were \$15,172 and \$50,000 for the three months ended June 30, 2011 and 2010, respectively.

Revenue for the six months ended June 30, 2011 was \$12,201,394 versus \$11,367,639 for the six months ended June 30, 2010, an increase of \$833,755 or 7%. Micron's medical sensors and snaps with silver surcharge revenue increased by \$2,232,895 and high volume precision molded products and other miscellaneous sales increased by \$149,120. The increase in revenues from sensors and snaps is due to increased volume in sensors and higher silver surcharge. Revenue from the Micron Integrated Technology's (MIT) product life cycle management programs decreased \$1,477,009. MIT's revenue is derived from the custom molding, precision metal machining and mold making activities. The revenue decreases reflect lower volume of defense industry products that were partially offset by higher tooling sales. Combined revenues from ART's software and WirelessDx services were \$28,749 and \$100,000 for the six months ended June 30, 2011 and 2010, respectively.

Revenue from domestic and foreign sales for the first three and six months is as follows:

	Three Months Ending June 30,				Six Months Ending June 30,			
	2011	%	2010	%	2011	%	2010	%
United States	\$ 2,256,889	37	\$ 2,930,635	51	\$ 4,923,184	40	\$ 6,038,855	53
Canada	2,453,400	41	1,414,690	25	4,357,289	36	2,754,700	24
Europe	517,162	9	655,997	11	1,160,422	10	1,145,159	10
Pacific Rim	332,682	5	419,066	7	842,654	7	810,362	7
Other	458,196	8	361,891	6	917,845	7	618,563	6
Total	\$ 6,018,329	100	\$ 5,782,279	100	\$ 12,201,394	100	\$ 11,367,639	100

The increase of sales in Canada, Europe and the Pacific Rim is due to increasing sensor revenue. The decrease of sales in United States is related to a reduction in defense industry products.

Cost of sales was \$4,994,063 or 83% of revenue for the three months ended June 30, 2011 as compared to \$4,687,802 or 81% of revenue for the same period in 2010. Cost of sales was \$9,798,842 or 80% of revenue for the six months ended June 30, 2011 as compared to \$9,289,014 or 82% of revenue for the same period in 2010. The stabilization and reduction of costs remains a priority of management. The inability to increase our sensor prices in the competitive global marketplace hinders passing additional material and utility cost increases to our customers, excluding the escalating cost of silver. As silver increases in price, the additional cost is passed to customers in the form of a silver surcharge, resulting in a decreased gross margin as a percentage of sales. The improvement in margin in the six months ended June 30, 2011 is despite the aforementioned escalating cost of silver. The improvements from automation and in process controls continue to positively contribute to gross profit. Management continues to investigate ways to improve the overall gross margin by focusing marketing efforts on higher margin products and investing in new technologies.

Selling and marketing expense was \$413,517 or 7% of sales for the three months ended June 30, 2011 as compared to \$255,637 or 4% for the same period in 2010. The selling and marketing expense was \$773,530 or 6% of sales in the six months ended June 30, 2011 and \$413,626 or 4% for the same period in 2010. The increase during the six months ended June 30, 2011 compared to the same period in 2010 includes \$276,000 and \$48,000 in personnel and travel expenses related to the WirelessDx medical services and ART software new sales and marketing costs, respectively. The remainder of the increase in expense was on travel expenses associated with Micron's sensor business and MIT's custom products. When compared to the three months ended June 30, 2010, the Company added four additional employees targeting the service markets, and one additional person in the custom manufacturing business. Selling expenses for WirelessDx is expected to continue to increase as the operations are scaled according to the Company's plans. As a percentage of sales, selling expenses will increase as there will be a timing lag between the additional expense and the expected revenue increases through the remainder of 2011.

General and administrative expense was \$920,473 or 15% of sales for the three months ended June 30, 2011 as compared to \$671,862 or 12% for the same period in 2010. The general and administrative expense was \$1,798,843 or 15% of sales in the six months ended June 30, 2011 and \$1,275,859 or 11% for the same period in 2010. The increase during the six months ended June 30, 2011 includes \$434,000 associated with the administrative infrastructure for WirelessDx office, travel and other administrative expenses associated with this new entity. These expenses are expected to continue to increase as WirelessDx operations expand. The remainder of the increased expense includes higher personnel cost, legal, travel and other corporate expenses. As of the June 30, 2011 measurement date, the Company is not an accelerated filer; therefore, the expense related to auditor attestation for Section 404b of the Sarbanes-Oxley Act of 2002 will not be incurred in 2011.

Research and development expense was \$106,656 or 2% of sales for the three months ended June 30, 2011 as compared to \$47,138 or 1% for the same period in 2010. The research and development expense was \$187,864 or 2% of sales in the six months ended June 30, 2011 as compared to \$102,811 or 1% in the same period in 2010. In 2011 and 2010, approximately 50% of the expense was related to ART's SAECG software, Predicto<sup>®</sup>. Product testing and development costs continue in support of a National Institutes of Health research project utilizing ART's proprietary Signal Averaged ECG products. The remaining portion of the research and development expense is associated with continued work on process improvements to Micron sensor and snap product line. This work is expected to continue through the end of 2011. Both areas of research and development have resulted in the filing of provisional patent applications.

Other income (expense), net was an income of \$5,351 versus income of \$144,647 for the three months ended June 30, 2011 and 2010, respectively. Other income (expense), net was an expense of \$5,211 versus income of \$144,769 for the six months ended June 30, 2011 and 2010, respectively. Interest income in the six months ended June 30, 2011 was offset by sale of assets totaling \$6,539 and a loss in currency exchange of \$18,821 associated with WirelessDx's

Canadian operations. In the six months ended June 30, 2010 the acquisition of RMDDx resulted in a onetime non-cash gain of \$146,288 in the period due to purchase accounting.

Income taxes as a percent of income before income taxes were 38% for the three months ended June 30, 2011 as compared to 17% for the same period in 2010. For the six months ended June 30, 2011, the effective rate of income tax benefit was 37% compared to income tax provision of 25% for the same period in 2010. The higher benefit rate is based on estimated utilization of operating losses in the near term. Management will continue to seek to implement any tax planning opportunities that could effectively reduce the Company's income tax obligations in the future.

## Liquidity and Capital Resources

Working capital was \$9,112,833 at June 30, 2011 compared to \$8,902,507 at December 31, 2010, an increase of \$210,326. Capital investment may decrease working capital with any significant investment resulting from future acquisition of capital assets or businesses, significant expansion of production capacity, or further software development.

Net capital expenditures were \$780,982 for the first six months of 2011 as compared to \$840,869 for the same period in 2010. The largest portion of the capital expenditures in the first six months of 2011 resulted from increased investment in medical devices used by the medical services business with the remainder being deployed for the routine replacement of production equipment and tooling on the sensor product line. Capital expenditures for the six months ended June 30, 2011 were made with cash on hand. The Company has made a commitment for a 200 KW solar installation at the Micron manufacturing facility. This installation is expected to reduce electricity consumption annually by approximately \$30,000 while generating an estimated \$120,000 in solar renewable energy credit income each year for the next ten years. The installation also qualifies for significant Federal and State tax credits.

The Company has an unsecured \$2,000,000 credit line with a large multinational bank. The agreement provides for borrowings up to 80% of eligible accounts receivable plus 50% of raw material and finished goods inventories. This facility has no borrowing base charge. The agreement contains covenants that apply upon drawing on the line. The covenants relate to various matters including notice prior to executing further borrowings and security interests, merger or consolidation, acquisitions, guarantees, sales of assets other than in the normal course of business, leasing, changes in ownership and payment of dividends. No funds have been drawn down on this line during the quarter ended June 30, 2011.

The Company's subsidiary, RMDDx, lifted restriction on \$510,833 of cash after providing a stand-by letter of credit related to a performance guarantee and Canadian Federal contracting economic incentive program involving an unrelated third party. The Company has secured a \$1,000,000 letter of credit to replace the guarantee by the Province of Prince Edward Island during the second quarter of 2011.

During the first quarter of 2011 payment terms with our silver supplier were modified. This modification resulted in a negative impact of approximately \$406,000 to cash flow from operations to date. The decrease in accounts payable resulting from the shorter payment terms with our silver supplier was done to offset an increase in material cost. The savings in the cost of materials was greater than the cost of capital to the Company. The savings in cost of materials was greater than the cost of capital to the Company.

The Company expects to meet cash demands for its operations at current levels with current operating cash flows for the foreseeable future.

During the six months ended June 30, 2011, the Board of Directors declared and paid a cash dividend of \$0.06 per share for a total of \$168,236. In the comparable period ended June 30, 2010, the Board of Directors declared and paid a cash dividend of \$0.06 per share for a total of \$161,328. Subsequent to the end of the reporting period, the Board of Directors declared a cash dividend of \$0.06 per share for a total of \$168,236 to be paid on August 12, 2011 to shareholders of record as of August 1, 2011.

In October 2008, the Company's Board of Directors authorized the repurchase in the open market from time to time of up to \$650,000 of the Company's outstanding stock. To date an aggregate of 36,199 shares were purchased under the program to date for an aggregate of \$87,163. No purchases were made in the first six months of 2011 or 2010.

## Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with generally accepted accounting principles requires management to make judgments, assumptions and estimates that affect the amounts reported. Certain of these significant accounting policies are considered to be critical accounting policies, as defined below.

A critical accounting policy is defined as one that is both material to the presentation of the Company's financial statements and requires management to make difficult, subjective, and complex judgments that could have a material effect on the Company's financial condition and results of operations. Specifically, critical accounting estimates have the following attributes: 1) the Company is required to make assumptions about matters that are highly uncertain at the time of the estimate; and 2) different estimates the Company could reasonably have used, or changes in the estimate that are reasonably likely to occur, would have a material effect on the Company's financial condition or results of operations.

Estimates and assumptions about future events and their effects cannot be determined with certainty. The Company bases its estimates on historical experience and on various other assumptions believed to be applicable and reasonable in the circumstances. These estimates may change as new events occur, as additional information is obtained and as the Company's operating environment changes. These changes have historically been minor and have been included in the consolidated financial statements as soon as they became known. In addition, management is periodically faced with uncertainties, the outcomes of which are not within its control and will not be known for prolonged periods of time. These uncertainties are discussed in the section above entitled "Forward-looking Statements." Based on a critical assessment of its accounting policies and the underlying judgments and uncertainties affecting the application of those policies, management believes that the Company's consolidated financial statements are fairly stated in accordance with generally accepted accounting principles, and present a meaningful presentation of the Company's financial condition and results of operations.

Management believes that the following are critical accounting policies:

#### Revenue Recognition and Accounts Receivable

The Company recognizes revenue upon product shipment or customer acceptance of completion of service provided, with persuasive evidence of an arrangement, the fee is fixed or determinable, and collectability of the related receivable is reasonably assured. The acceptance of the service by RMDDx is the prearranged transmission of medical records into the customer owned database. The Company recognizes software license revenue upon completion of performance obligations by the Company and evidence of licenses transmitted from the control of the Company.

Products are shipped to the customer with the warranty that the product meets the mutually agreed specifications as detailed on the purchase order. Upon agreement within 90 days of shipment between the Company and customer that the product did not conform to the agreed upon specifications, a return is authorized, credited and product returned is replaced.

Based on management's on-going analysis of accounts receivable balances, and after the initial recognition of the revenue, as to any event that adversely affects the ultimate ability to collect the related receivable, management will record an allowance for bad debts. Bad debts have not had a significant impact on the Company's financial position, results of operations and cash flows.

#### Stock-Based Compensation

The Company accounts for share based compensation under ASC 718, "Stock Compensation" ("ASC 718"). ASC 718 requires that companies recognize and measure compensation expense for all share-based payments at the grant date based on the fair market value of the award. This share-based compensation expense must be included in the Company's statement of operations over the requisite service period.

The Company uses the Black-Scholes option pricing model which requires extensive use of financial estimates and accounting judgment, including the expected volatility of the Company's common stock over the estimated term, and estimates on the expected time period that employees will retain their vested options prior to exercising them. The use of alternative assumptions could produce significantly different estimates of the fair value of the stock-based compensation and as a result, provide significantly different amounts recognized in the Company's statement of income.

#### Inventory and Inventory Reserves

The Company values its inventory at the lower of average cost or market. The Company reviews its inventory for quantities in excess of production requirements, obsolescence and for compliance with internal quality specifications. Any adjustments to inventory would be equal to the difference between the cost of inventory and the estimated net market value based upon assumptions about future demand, market conditions and expected cost to distribute those products to market. Silver in its delivered form is priced at fair market value.

The Company maintains some reserve for excess, slow moving, and obsolete inventory. A review of inventory on hand is made at least annually and some obsolete inventory is scrapped and/or recycled. The review is based on several factors including a current assessment of future product demand, historical experience, and product expiration.



#### Deferred Tax Assets

The Company assesses its deferred tax assets based upon a more likely than not to be realized criteria. The Company considers future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance. In accordance with ASC 740 we recognize the benefits of a tax position if that position is more likely than not to be sustained on audit, based on the technical merit of the position.

#### Asset Impairment – Goodwill

The Company reviews the valuation of goodwill and intangible assets to assess potential impairments. Management reassesses the useful lives of other intangible assets with identifiable useful lives in accordance with the guidelines set forth in ASC 350, “Intangible Assets”. The value assigned to intangible assets is determined by a valuation based on estimates and judgment regarding expectations for the success and life cycle of products previously acquired or others likely to be acquired in the future. If the actual sale of product and market acceptance differs significantly from the estimates, management may be required to record an impairment charge to write down the asset to its realizable value. To test for impairment, a present value of an estimate of future cash flows related to goodwill or intangible assets with indefinite lives are calculated and compared to the value of the intangible asset during the first quarter annually. When impairment exists it could have a material adverse effect on the Company’s business, financial condition and results of operations. After the annual testing was completed as of March 31, 2011, no impairment of goodwill was required.

#### Asset Impairment – Long Lived Assets

The Company assesses the impairment of long-lived assets and intangible assets with finite lives whenever events or changes in circumstances indicate that the carrying value may not be fully recoverable. When the Company’s management determines that the carrying value of such assets may not be recoverable, management generally measures any impairment on a projected discounted cash flow method using a discount rate determined by management to be commensurate with the risk inherent in its current business model.

#### Item 3. Quantitative and Qualitative Disclosure About Market Risks

Not applicable.

#### Item 4. Controls and Procedures

##### Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this Quarterly Report, the Company’s management, with the participation of the Company’s Chief Executive Officer and Chief Financial Officer (“the Certifying Officers”), conducted evaluations of the Company’s disclosure controls and procedures as defined under Sections 13a – 15(e) and 15d – 15(e) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Based on this evaluation, the Certifying Officers have concluded that the Company’s disclosure controls and procedures were effective to ensure that material information is recorded, processed, summarized and reported by management of the Company on a timely basis in order to comply with the Company’s disclosure obligations under the Exchange Act and the rules and regulations promulgated thereunder.

##### Changes in Internal Control over Financial Reporting

Further, there were no changes in the Company's internal control over financial reporting during the Company's second fiscal quarter that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 7. Exhibits

(a) Exhibits

- 3.0 Articles of Incorporation <sup>(a)</sup>
- 3.1 Amended and Restated By-laws<sup>(b)</sup>
- 10.43\* Employment agreement between James E. Rouse and the company dated December 26<sup>th</sup>, 2006. <sup>(c)</sup>
- 10.44\* Employment agreement between David A. Garrison and the Company dated January 1<sup>st</sup>, 2007. <sup>(d)</sup>
- 31.1 Certification of the CEO pursuant to Rule 13a-14(a) or Rule 15(d)-14(a) on page X-1
- 31.2 Certification of the CFO pursuant to Rule 13a-14(a) or Rule 15(d)-14(a) on page X-2.
- 32.1 Certification pursuant to 18 U.S.C. §1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 on page X-3.
- 32.2 Certification pursuant to 18 U.S.C. §1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 on page X-4.
- 101.INS† XBRL Instance Document
- 101.SCH† XBRL Taxonomy Extension Schema Document
- 101.CAL† XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF † XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB† XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE† XBRL Taxonomy Extension Presentation Linkbase Document

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\* Indicates a management contract or compensatory plan required to be filed as an exhibit.

† XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

- (a) Incorporated by reference from the Company's Registration Statement on Form S-18 as filed with the Commission in April 1988, Registration Statement No. 33-20945-FW.
- (b) Incorporated by reference from the Company's Form 8-K as filed with the Commission May 8, 2009.
- (c) Incorporated by reference from the Company's Form 8-K as filed with the Commission on December 8, 2006.
- (d) Incorporated by reference from the Company's Form 10-KSB for period ended December 31, 2006 as filed with the Commission in March of 2007.

SIGNATURES

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

ARRHYTHMIA RESEARCH TECHNOLOGY, INC.

August 15, 2011

By: /s/ James E. Rouse  
James E. Rouse  
President and Chief Executive Officer  
(Principal Executive Officer)

By: /s/ David A. Garrison  
David A. Garrison  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

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Index to Exhibits

Number	Exhibit	Page
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