STERIS CORP
Form 10-Q
November 07, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

or

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

For the transition period from to

Commission File Number 1-14643

STERIS Corporation

(Exact name of registrant as specified in its charter)

Ohio	**34-1482024**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
5960 Heisley Road, Mentor, Ohio	**44060-1834**
(Address of principal executive offices)	**(Zip code)**

440-354-2600

(Registrant s telephone number, including area code)

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 x No ¨

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

Large Accelerated Filer x Accelerated Filer ¨ Non-Accelerated Filer ¨

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

The number of common shares outstanding as of October 31, 2006: 64,625,708

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STERIS Corporation

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

STERIS CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands)

	September 30, 2006	March 31, 2006
	(Unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$ 44,907	$ 72,732
Accounts receivable (net of allowances of $8,217 and $9,037, respectively)	201,497	242,002
Inventories, net	140,955	112,224
Current portion of deferred income taxes, net	13,232	13,021
Prepaid expenses and other current assets	36,995	20,336
Total current assets	437,586	460,315
Property, plant, and equipment, net	393,320	401,536
Goodwill and intangibles, net	333,068	326,529
Other assets	529	593
Total assets	$ 1,164,503	$ 1,188,973
Liabilities and shareholders equity		
Current liabilities:		
Current portion of long-term indebtedness	$ 1,402	$ 1,755
Accounts payable	66,559	87,057
Accrued income taxes	9,872	19,821
Accrued payroll and other related liabilities	46,711	50,496
Accrued expenses and other	72,506	75,017
Total current liabilities	197,050	234,146
Long-term indebtedness	147,035	114,480
Deferred income taxes, net	28,633	35,135
Long-term portion of retirement benefit obligations	74,983	74,385
Total liabilities	447,701	458,146
Serial preferred shares, without par value; 3,000 shares authorized; no shares issued or outstanding		
Common shares, without par value; 300,000 shares authorized; issued and outstanding shares of 64,624 and 66,976, respectively	90,308	141,723

Retained earnings	622,650	596,878
Accumulated other comprehensive (loss) income:		
Minimum pension liability	(6,214)	(6,214)
Cumulative foreign currency translation adjustment	10,058	(1,560)
Total shareholders equity	716,802	730,827
Total liabilities and shareholders equity	$ 1,164,503	$ 1,188,973

See notes to consolidated financial statements.

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STERIS CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Revenues:				
Product	$ 179,375	$ 174,846	$ 345,134	$ 343,992
Service	104,161	98,590	203,469	197,527
Total revenues	283,536	273,436	548,603	541,519
Cost of revenues:				
Product	106,347	103,425	201,640	199,385
Service	58,428	56,828	114,827	113,375
Total cost of revenues	164,775	160,253	316,467	312,760
Gross profit	118,761	113,183	232,136	228,759
Operating expenses:				
Selling, general, and administrative	82,786	78,648	161,200	159,880
Research and development	8,283	9,096	16,678	16,837
Restructuring expenses	1,158		2,263	
Total operating expenses	92,227	87,744	180,141	176,717
Income from continuing operations	26,534	25,439	51,995	52,042
Non-operating expenses (income):				
Interest expense	2,376	1,303	4,145	2,524
Interest and miscellaneous income	(801)	(365)	(1,480)	(2,292)
Total non-operating expense, net	1,575	938	2,665	232
Income from continuing operations before income tax expense	24,959	24,501	49,330	51,810
Income tax expense	8,599	9,096	18,913	19,473
Net income from continuing operations	16,360	15,405	30,417	32,337
Discontinued operations:				
Income from discontinued operations, net of tax		1,010		1,410
Gain on the sale of discontinued operations, net of tax			627	
Net income	$ 16,360	$ 16,415	$ 31,044	$ 33,747
Basic earnings per common share:				

Income from continuing operations, net of tax	$ 0.25	$ 0.23	$ 0.46	$ 0.47
Income from discontinued operations, net of tax	$	$ 0.01	$ 0.01	$ 0.02
Net income	$ 0.25	$ 0.24	$ 0.47	$ 0.49
Diluted earnings per common share:				
Income from continuing operations, net of tax	$ 0.25	$ 0.23	$ 0.46	$ 0.47
Income from discontinued operations, net of tax	$	$ 0.01	$ 0.01	$ 0.02
Net income	$ 0.25	$ 0.24	$ 0.47	$ 0.49
Cash dividends declared per common share outstanding	$ 0.04	$ 0.04	$ 0.08	$ 0.08

See notes to consolidated financial statements.

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STERIS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Six Months Ended September 30, 2006	Six Months Ended September 30, 2005
Operating activities:		
Net income	$ 31,044	$ 33,747
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion, and amortization	29,677	28,432
Deferred income taxes	(7,158)	(285)
Share based compensation	5,785	
Tax benefit from stock options exercised		1,173
Gain on the sale of discontinued operations, net of tax	(627)	
Other items	856	(1,113)
Changes in operating assets and liabilities, excluding the effects of business acquisitions:		
Accounts receivable, net	43,568	41,554
Inventories, net	(27,123)	(13,352)
Other current assets	(19,382)	(2,385)
Accounts payable	(21,287)	(6,202)
Accruals and other, net	(17,093)	5,913
Assets of discontinued operations		10,139
Liabilities of discontinued operations		(11,970)
Net cash provided by operating activities	18,260	85,651
Investing activities:		
Purchases of property, plant, equipment, and intangibles, net	(21,419)	(22,665)
Purchases of property, plant, equipment, and intangibles, net for discontinued operations		(72)
Investments in businesses, net of cash acquired		(1,504)
Proceeds from the sale of discontinued operations	2,927	
Net cash used in investing activities	(18,492)	(24,241)
Financing activities:		
Proceeds under credit facilities, net	32,555	1,700
Payments on long-term obligations and capital leases, net	(361)	(1,932)
Repurchases of common shares	(59,628)	(39,394)
Cash dividends paid to common shareholders	(5,272)	(5,494)
Deferred financing fees		(217)
Stock option and other equity transactions, net	1,825	5,992
Tax benefit from stock options exercised	551	
Net cash used in financing activities	(30,330)	(39,345)
Effect of exchange rate changes on cash and cash equivalents	2,737	(530)

(Decrease) increase in cash and cash equivalents	(27,825)	21,535
Cash and cash equivalents at beginning of period	72,732	23,547
Cash and cash equivalents at end of period	$ 44,907	$ 45,082

See notes to consolidated financial statements.

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

1. Nature of Operations and Summary of Significant Accounting Policies

Throughout this document, references to STERIS Corporation, STERIS, or the Company, are references to STERIS Corporation and its subsidiaries, except where a different meaning is clearly required by the context. The Company s fiscal year ends on March 31. References to a particular year or year-end refer to the Company s fiscal year.

Nature of Operations

The Company develops, manufactures, and/or markets equipment, consumables, and services for healthcare, pharmaceutical, scientific, research, industrial, and governmental customers throughout the world. The Company operates in three business segments: Healthcare, Life Sciences, and STERIS Isomedix Services.

Interim Financial Statements

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles (U.S. GAAP) for complete financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements contain all material adjustments (including normal recurring accruals and adjustments) necessary to present fairly the financial condition, results of operations, and cash flows of the Company for the periods presented.

These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended March 31, 2006, filed with the Securities and Exchange Commission (SEC) on June 12, 2006. The Consolidated Balance Sheet at March 31, 2006 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Inter-company accounts and transactions have been eliminated upon consolidation.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions in certain circumstances that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates and, therefore, operating results for the three and six month periods ended September 30, 2006 are not necessarily indicative of results that may be expected for the full fiscal year ending March 31, 2007.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period s presentation.

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

Share-Based Compensation

On April 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS No. 123R), Share-Based Payment, and elected to use the modified prospective transition method (see Note 2).

New Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 158 (SFAS No. 158), Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132(R), requiring public companies to fully recognize an asset or liability for the overfunded or underfunded status of their benefit plans and requiring the use of a measurement date that corresponds to the plan sponsor s year end. The recognition and disclosure provisions of SFAS No. 158 are effective for fiscal years ending after December 15, 2006. The measurement date provision of SFAS No. 158 is effective for fiscal years beginning after December 15, 2008. The Company currently measures plan assets and benefit obligations of its defined benefit pension and postretirement benefit plans as of its fiscal year-end balance sheet date. The Company will adopt the recognition and disclosure provisions of SFAS No. 158 as of March 31, 2007, as required. Management is currently evaluating the requirements of SFAS No. 158 and has not yet determined the impact on the Company s consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS No. 157), Fair Value Measurements, providing enhanced guidance on the use of fair value to measure assets and liabilities. SFAS No. 157 also provides for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard does not expand the use of fair value, but applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company will adopt SFAS No. 157 as of April 1, 2008, as required. Management is currently evaluating the requirements of SFAS No. 157 and has not yet determined the impact on the Company s consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements, providing interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a potential current year misstatement. SAB 108 is effective for fiscal years beginning after November 15, 2006. The Company will adopt SAB 108 as of April 1, 2007, as required. Management is currently evaluating the requirements of SAB 108 and has not yet determined the impact on the Company s consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, Accounting for Income Taxes, to create a single model to address accounting for uncertainty in tax positions. FIN 48 prescribes a benefit recognition model with a two-step approach, a more-likely-than-not recognition criterion and a measurement attribute that measures the position as the largest amount of tax benefit that is greater than 50% likely of being ultimately realized upon settlement. If it is not more-likely-than-not that the benefit will be sustained on its technical merits, no benefit will be recorded. FIN 48 also requires that the amount of interest expense to be recognized related to uncertain

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STERIS CORPORATION

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For the Three and Six Months Ended

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tax positions be recognized in accordance with applying the applicable statutory rate of interest to the difference between the tax position recognized in accordance with FIN 48 and the amount previously taken or expected to be taken in a tax return. The change in net assets as a result of applying this interpretation will be considered a change in accounting principle with the cumulative effect of the change treated as an offsetting adjustment to the opening balance of retained earnings or goodwill, if allowed under existing accounting standards, in the period of transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company will adopt FIN 48 as of April 1, 2007, as required. Management is currently evaluating the requirements of FIN 48 and has not yet determined the impact on the Company s consolidated financial statements.

Significant Accounting Policies

A detailed description of the Company s significant and critical accounting policies, estimates, and assumptions is included in the Company s Annual Report on Form 10-K for the year ended March 31, 2006, filed with the SEC on June 12, 2006. The Company s significant and critical accounting policies, estimates, and assumptions have not changed materially from March 31, 2006, other than the adoption of SFAS No. 123R as described above.

2. Share-Based Compensation

Under the Company s long-term incentive plan, up to 6,600,000 shares of common stock have been made available for grant at the discretion of the Compensation Committee of the Board of Directors to officers, directors, and key employees in the form of stock options, restricted shares, and restricted share units. Stock options provide the right to purchase the Company s common shares at the market price on the date of grant, subject to the terms of option plans and agreements. Stock options granted generally become exercisable to the extent of one-fourth of the optioned shares for each full year of employment following the date of grant and generally expire 10 years after the date of grant, or earlier if an option holder ceases to be employed by the Company. Certain option agreements have provisions that provide for an adjustment to the normal vesting schedule whereby options vest on a prorated basis as defined by specific option agreements in the event of employment termination. Restricted shares and restricted share units cliff vest over an approximately three-year period. As of September 30, 2006, 6,096,325 shares remain available for grant under the long-term incentive plan.

Prior to April 1, 2006, the Company accounted for share-based compensation under the provisions of Accounting Principles Board Opinion No. 25 (APB No. 25), Accounting for Stock Issued to Employees, as permitted by Statement of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock-Based Compensation, as amended by Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, and accordingly recognized no compensation expense when the exercise price equaled the market price of the stock on the date of grant.

On April 1, 2006, the Company adopted SFAS No. 123R using the modified prospective transition method. SFAS No. 123R requires the Company to estimate the fair value of share-based awards on the date of the grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company s consolidated statements of income. The expense is classified as cost of goods sold or selling, general and administrative expenses in a manner consistent with the employee s compensation and benefits.

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

Under the modified prospective transition method, compensation cost recognized in the first six months of fiscal 2007 includes (a) compensation cost for all share-based compensation granted, but not yet vested, as of April 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based compensation granted on or subsequent to April 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. The Company s consolidated financial statements as of and for the three and six month periods ended September 30, 2006 reflect the impact of SFAS No. 123R. In accordance with the modified prospective transition method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include the impact of SFAS No. 123R.

The adoption of SFAS No. 123R on April 1, 2006 reduced the Company s income from continuing operations before income taxes for the second quarter and first half of fiscal 2007 by $3,693 and $5,785, respectively, and reduced net income for the second quarter and first half of fiscal 2007 by $2,268 ($0.03 per basic and diluted share) and $3,553 ($0.05 per basic and diluted share), respectively. The adoption of SFAS No.123R also required the classification of the tax benefit from the exercise of stock options for the six months ended September 30, 2006 of $551 as a financing activity in the cash flow statement, rather than as an operating activity, as previously required. For the six months ended September 30, 2005, the tax benefit from the exercise of stock options recorded as an operating activity in the cash flow statement was $1,173.

The effect of the adoption of SFAS No. 123R on the first half of fiscal 2007 results is not indicative of the effect on the second half of fiscal 2007, as approximately $1,784 of the first half stock compensation was attributable to the accelerated recognition of expense for certain employees that are or will become eligible for retirement during the vesting period.

The following table contains pro forma disclosures regarding the effect on the Company s net income, earnings per basic common share, and earnings per diluted common share for the second quarter and first half of fiscal 2006 had the Company applied a fair value method of accounting for share-based compensation in accordance with SFAS No. 123.

	Three Months Ended September 30, 2005	Six Months Ended September 30, 2005
Net income:		
As reported	$ 16,415	$ 33,747
Less: Stock-based compensation expense, net of income taxes, assuming the fair value method	1,398	2,874
Pro forma	$ 15,017	$ 30,873

Earnings per common share:				
Basic:				
As reported	$	0.24	$	0.49
Pro forma		0.22		0.45
Diluted:				
As reported	$	0.24	$	0.49
Pro forma		0.22		0.44

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

For the purpose of computing pro forma net income, the fair value of option grants was estimated at their grant date using the Black-Scholes-Merton option pricing model. This model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, characteristics that are not present in the Company s option grants. If the model permitted consideration of the unique characteristics of employee stock options, the resulting estimate of the fair value of the stock options could be different.

The following weighted-average assumptions were used for all options granted during the first half of fiscal 2007 and fiscal 2006:

	SFAS No. 123R Expense	SFAS No. 123 Pro forma
	Fiscal 2007	Fiscal 2006
Risk-free interest rate	4.73%	3.95% - 4.40%
Expected life of options	6 years	5 years
Expected dividend yield of stock	0.65%	0.58% - 0.66%
Expected volatility of stock	34.29%	45.00%

The risk-free interest rate is based upon the U.S. Treasury yield curve at the time of grant. The expected life of options is reflective of historical experience, vesting schedules and contractual terms. The expected dividend yield of stock represents the Company s best estimate of expected future dividend yield. The expected volatility of stock is derived by referring to the Company s historical stock prices over a timeframe similar to that of the expected life of the grant. The Company has applied an estimated forfeiture rate of 2.2 percent. This rate is calculated based upon historical activity and represents an estimate of the granted options not expected to vest. If actual forfeitures differ from the expected rate, the Company may be required to make additional adjustments to compensation expense in future periods. The expected life and expected forfeiture rate used for options granted in fiscal 2007 to the Company s Chief Executive Officer (CEO) were adjusted based on the terms of the employment agreement between the Company and the CEO entered into in September 2006.

Stock option activity for the first half of fiscal 2007 is as follows:

	Number of	Weighted Average	Weighted Average Remaining	Aggregate Intrinsic

	Options	Exercise Price	Contractual Term	Value
Outstanding at March 31, 2006	5,706,874	$ 21.02		
Granted	415,725	24.72		
Exercised	(159,662)	14.78		
Forfeited	(61,332)	25.02		
Outstanding at September 30, 2006	5,901,605	$ 21.07	6.09	$ 126,459
Exercisable at September 30, 2006	4,282,083	$ 20.02	5.15	$ 85,708

The total intrinsic value of stock options exercised during the first half of fiscal 2007 and fiscal 2006 was $1,464 and $3,151, respectively. Net cash proceeds from the exercise of stock options were $2,381 and $5,983 for the first half of fiscal 2007 and fiscal 2006, respectively. An income tax benefit of $551 and $1,173 was realized from stock option exercises during the first half of fiscal 2007 and fiscal 2006, respectively.

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

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(dollars in thousands, except per share amounts)

The weighted average grant date fair value of share-based compensation grants was $9.75 and $10.57 for the first half of fiscal 2007 and fiscal 2006, respectively. The weighted average grant date fair value of share-based compensation granted to the CEO was adjusted based on the terms of the employment agreement between the Company and the CEO entered into in September 2006.

A summary of the status of the Company s nonvested shares as of September 30, 2006 and changes during the first half of fiscal 2007 is presented below:

	Number of Restricted Shares	Number of Restricted Share Units	Weighted-Average Grant Date Fair Value
Nonvested at March 31, 2006	2,200		$ 27.20
Granted	67,100	20,850	23.17
Vested	(1,470)		27.20
Canceled			
Nonvested at September 30, 2006	67,830	20,850	$ 23.20

Restricted shares and restricted share units granted were valued based on the closing stock price at the grant date and are estimated to cliff vest over an approximately three-year period based upon the terms of the grants. The total intrinsic value of restricted shares that vested during the first half of fiscal 2007 was $34.

As of September 30, 2006, there was $14,763 of total unrecognized compensation cost related to non-vested share-based compensation granted under the Company s share-based compensation plans. The cost is expected to be recognized over a weighted average period of 1.21 years.

3. Common Shares

Basic earnings per common share are calculated based upon the weighted average number of common shares outstanding. Diluted earnings per common share are calculated based upon the weighted average number of common shares outstanding plus the dilutive effect of common share equivalents calculated using the treasury stock method. The following is a summary of common shares and common share equivalents outstanding used in the calculations of basic and diluted earnings per common share:

	Three Months Ended September 30,		**Six Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
	(shares in thousands)			
Weighted average common shares outstanding - basic	65,567	68,196	65,882	68,661
Dilutive effect of common share equivalents	552	783	509	771
Weighted average common shares outstanding and common share equivalents - diluted	66,119	68,979	66,391	69,432

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

Options to purchase the following number of common shares at the following weighted average exercise prices were outstanding but excluded from the computation of diluted earnings per common share because the exercise prices were greater than the average market price for the common shares during the periods:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
		(shares in thousands)		
Number of common share options	2,169	1,495	2,124	1,495
Weighted average exercise price	$ 26.75	$ 28.44	$ 26.80	$ 28.44

4. Comprehensive Income

Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income, establishes standards for reporting comprehensive income. Comprehensive income includes net income as currently reported under U.S. GAAP and other comprehensive income. Other comprehensive income considers the effects of additional economic events that are not required to be recorded in determining net income, but rather are reported as a separate component of shareholders equity. The following table illustrates the components of the Company s comprehensive income:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Net income	$ 16,360	$ 16,415	$ 31,044	$ 33,747
Foreign currency translation adjustments	2,795	(420)	11,618	(10,273)
Total comprehensive income	$ 19,155	$ 15,995	$ 42,662	$ 23,474

5. Restructuring

During the three and six months ended September 30, 2006, the Company recorded $1,158 and $2,263, respectively, in restructuring expenses related to the transfer of the Erie, Pennsylvania manufacturing operations to Monterrey, Mexico to improve the Company s cost structure. The following is a summary of these restructuring expenses for the second quarter and first half of fiscal 2007:

	Three Months Ended September 30, 2006	Six Months Ended September 30, 2006
Asset impairment and accelerated depreciation	$ 564	$ 1,269
Severance, payroll and other related costs	589	979
Other	5	15
Total restructuring charges	$ 1,158	$ 2,263

These costs are associated with the Healthcare business segment. Since the inception of the restructuring plan, the Company has incurred restructuring expenses of $27,571, with restructuring expenses of $27,089 and $482 related to the Healthcare and Life Sciences segments, respectively. These charges primarily related to the transfer of manufacturing operations to Monterrey, Mexico.

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

The Company anticipates incurring approximately an additional $15,700 in restructuring expenses during the remainder of fiscal 2007 and fiscal 2008 in connection with the transfer of the manufacturing operations. Restructuring expenses to be incurred include compensation and benefits, severance, accelerated depreciation and other expenses. The Company did not incur restructuring expenses during the first half of fiscal 2006.

Restructuring expenses have been recognized as incurred as required under the provisions of Statement of Financial Accounting Standards No. 146 (SFAS No. 146), Accounting for Costs Associated with Exit or Disposal Activities. In addition, the property, plant and equipment associated with the Erie, Pennsylvania facility were assessed for impairment under Statement of Financial Accounting Standards No. 144 (SFAS No. 144), Accounting for the Impairment or Disposal of Long-Lived Assets. Asset impairment and accelerated depreciation expenses primarily relate to adjustments to the carrying value and the estimated useful lives of the assets of the Erie facility to reflect their estimated fair value.

Liabilities related to restructuring activities are recorded as current liabilities on the accompanying Consolidated Balance Sheets within Accrued expenses and other. The following table summarizes the Company s liabilities related to restructuring activities:

		Fiscal 2007		
	March 31, 2006	**Provision**	**Payments**	**September 30, 2006**
Severance and termination benefits	$ 1,941	$ 923	$ (1,385)	$ 1,479
Lease termination obligation	135		(74)	61
Total	$ 2,076	$ 923	$ (1,459)	$ 1,540

6. Depreciable Assets

Information related to the major categories of the Company s depreciable assets is as follows:

	September 30,	**March 31,**

	2006	2006
Land and land improvements (1)	$ 25,458	$ 24,611
Buildings and leasehold improvements	181,583	179,264
Machinery and equipment	262,956	259,820
Information systems	110,642	108,853
Radioisotope	128,260	125,008
Construction in progress (1)	33,065	31,554
Total property, plant, and equipment	741,964	729,110
Less: accumulated depreciation and depletion	(348,644)	(327,574)
Property, plant, and equipment, net	$ 393,320	$ 401,536

(1) Land is not depreciated. Construction in progress is not depreciated until placed in service.

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

7. Inventories, Net

Inventories, net are stated at the lower of cost or market. The Company uses the last-in, first-out (LIFO) and first-in, first-out (FIFO) cost methods. An actual valuation of inventory under the LIFO method is made only at the end of the fiscal year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations are based on management s estimates of expected year-end inventory levels and are subject to the final fiscal year-end LIFO inventory valuation. Inventory costs include material, labor, and overhead. Inventories, net consisted of the following:

	September 30, 2006	March 31, 2006
Raw materials	$ 35,344	$ 32,121
Work in process	31,324	29,011
Finished goods	74,287	51,092
Inventories, net	$ 140,955	$ 112,224

8. Debt

Indebtedness was as follows:

	September 30, 2006	March 31, 2006
Private Placement	$ 100,000	$ 100,000
Credit facility	45,535	12,980
Other debt	2,902	3,255
Total	148,437	116,235
Less: current portion	1,402	1,755

Long-term portion	$ 147,035	$ 114,480

Additional information regarding the Company s indebtedness is included in the Company s Annual Report on Form 10-K for the year ended March 31, 2006, filed with the SEC on June 12, 2006.

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

9. Additional Consolidated Balance Sheets Information

Additional information related to the Company s Consolidated Balance Sheets is as follows:

	September 30, 2006	March 31, 2006
Accrued payroll and other related liabilities:		
Compensation and related items	$ 16,749	$ 14,646
Accrued vacation	11,646	12,912
Accrued bonuses	4,939	3,542
Accrued employee commissions	6,359	9,474
Retirement benefit obligations-current portion	7,018	9,922
Total accrued payroll and other related liabilities	$ 46,711	$ 50,496
Accrued expenses and other:		
Deferred revenues	$ 21,274	$ 19,408
Self-insured risk retention-GRIC	17,629	16,090
Other self-insured risks	930	1,407
Accrued dealer commissions	5,709	6,067
Accrued warranty	5,725	7,226
Other	21,239	24,819
Total accrued expenses and other	$ 72,506	$ 75,017

10. Income Tax Expense

Income tax expense includes United States federal, state and local, and foreign income taxes, and is based on reported pre-tax income. The effective income tax rates for continuing operations for the three month periods ended September 30, 2006 and 2005 were 34.5% and 37.1%, respectively. For the six month periods ended September 30, 2006 and 2005, the effective income tax rates for continuing operations were 38.3% and 37.6%, respectively. The lower effective income tax rate for the three month period ended September 30, 2006 resulted principally from discrete item adjustments to recognize additional deferred tax assets related to foreign tax credits.

Income tax expense is provided on an interim basis based upon the Company s estimate of the annual effective income tax rate, adjusted each quarter for discrete items. In determining the estimated annual effective income tax rate, the Company analyzes various factors, including projections of the Company s annual earnings and taxing jurisdictions in which the earnings will be generated, the impact of state and local income taxes, the Company s ability to use tax credits and net operating loss carryforwards, and available tax planning alternatives.

11. Benefit Plans

The Company provides defined benefit pension plans for certain manufacturing and plant administrative personnel throughout the world as determined by collective bargaining agreements or employee benefit standards, including two United States defined benefit pension plans. In addition to providing pension benefits to certain employees, the Company sponsors an unfunded post-retirement medical benefit plan for two groups of United States employees comprised substantially of the same employees who receive pension benefits under the

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

United States defined benefit pension plans. Benefits under this plan include retiree life insurance and retiree medical insurance, including prescription drug coverage and Medicare supplemental coverage. Additional information regarding the Company s defined benefit pension plans and other post-retirement medical benefit plan is included in the Company s Annual Report on Form 10-K for the year ended March 31, 2006, filed with the SEC on June 12, 2006.

During the fourth quarter of fiscal 2006, the Company recorded curtailment and special termination benefit losses associated with the restructuring plan to transfer certain manufacturing operations from Erie, Pennsylvania to Monterrey, Mexico. Fiscal 2007 net periodic benefit costs are reduced as a result of the recognition of these losses.

Components of the net periodic benefit cost of the Company s defined benefit pension plans and other post-retirement medical benefit plan were as follows:

	Defined Benefit Pension Plans				Other Post-Retirement Plan	
	U.S. Qualified		International			
Three Months Ended September 30,	**2006**	**2005**	**2006**	**2005**	**2006**	**2005**
Service cost	$ 49	$ 222	$ 109	$ 227	$	$ 272
Interest cost	693	646	80	120	1,168	1,134
Expected return on plan assets	(680)	(697)	(97)	(125)		
Net amortization and deferral	67	209			231	438
Net periodic benefit cost	$ 129	$ 380	$ 92	$ 222	$ 1,399	$ 1,844

	Defined Benefit Pension Plans				Other Post-Retirement Plan	
	U.S. Qualified		International			
Six Months Ended September 30,	**2006**	**2005**	**2006**	**2005**	**2006**	**2005**

Service cost	$ 98	$ 444	$ 219	$ 380	$	$ 544
Interest cost	1,385	1,292	160	202	2,337	2,268
Expected return on plan assets	(1,360)	(1,394)	(194)	(210)		
Net amortization and deferral	134	418			461	876
Net periodic benefit cost	$ 257	$ 760	$ 185	$ 372	$ 2,798	$ 3,688

It is the Company s practice to fund amounts for the defined benefit pension plans at least sufficient to meet the minimum requirements set forth in applicable employee benefit laws and local tax laws. In September 2006, the Company contributed $3,125 to its defined benefit pension plans. Liabilities for amounts in excess of these funding levels are included on the accompanying Consolidated Balance Sheets of the Company.

12. Contingencies

The Company may be involved in various patent, product liability, consumer, environmental, tax proceedings and claims, governmental investigations, and other legal and regulatory proceedings that arise from time to time in the ordinary course of business. In accordance with Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, the Company records accruals for such contingencies to the extent that the Company concludes that their occurrence is both probable and estimable. The Company considers many factors in making these assessments,

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

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including the professional judgment of experienced members of management and the Company s legal counsel. The Company has made estimates as to the likelihood of unfavorable outcomes and the amounts of such potential losses. In the opinion of management, the ultimate outcome of these proceedings and claims is not anticipated to have a material adverse effect on the Company s consolidated financial position, results of operations, or cash flows. Legal and other proceedings are inherently unpredictable and actual results could materially differ from the Company s estimates. The Company records anticipated recoveries under applicable insurance contracts when assured of recovery.

The Food & Drug Administration (FDA) and the United States Department of Justice are continuing to conduct an investigation involving the Company s SYSTEM 1® sterile processing system. The Company received requests for documents in connection with the investigation. The Company has been responding to these requests and has been cooperating with the government agencies regarding this matter. There can be no assurance that the ultimate outcome of the investigation will not result in an action by the government agencies or that the government agencies will not initiate administrative proceedings, civil proceedings or criminal proceedings, or any combination thereof, against the Company.

To the extent that management of the Company believes it is probable that a taxing authority will take a sustainable position on a matter contrary to the position taken by the Company, the Company provides tax accruals. If the Company was to prevail in matters for which accruals have been established, or is required to pay amounts in excess of established accruals, the Company s effective income tax rate in a given financial statement period may be materially impacted.

13. Business Segment Information

The Company operates and reports in three business segments: Healthcare, Life Sciences, and STERIS Isomedix Services. Operating income (loss) for each of the Company s reportable business segments reflects the full allocation of all distribution, corporate, and research and development expenses to the reportable segments. These allocations are based upon variables such as segment headcount and revenues. The accounting policies for reportable segments are the same as those for the consolidated Company. Segment results for the three and six months ended September 30, 2005 exclude the freeze dryer product line, which has been presented as a discontinued operation, and reflect the reallocation of corporate overhead charges to all business segments. The freeze dryer product line was previously included in the Life Sciences business segment. For the three and six months ended September 30, 2006, revenues from a single customer did not represent ten percent or more of any segment s revenues. Additional information regarding the Company s business segments is included in the Company s Annual Report on Form 10-K for the year ended March 31, 2006, filed with the SEC on June 12, 2006.

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

Financial information for each of the Company s reportable business segments is presented in the following table:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
Revenues:				
Healthcare	$ 197,094	$ 193,995	$ 384,225	$ 379,755
Life Sciences	52,951	47,441	98,332	97,258
STERIS Isomedix Services	33,491	32,000	66,046	64,506
Total revenues	$ 283,536	$ 273,436	$ 548,603	$ 541,519
Operating income (loss):				
Healthcare	$ 20,426	$ 21,995	$ 41,539	$ 44,549
Life Sciences	275	(1,396)	(1,038)	(3,552)
STERIS Isomedix Services	5,833	4,840	11,494	11,045
Total operating income	$ 26,534	$ 25,439	$ 51,995	$ 52,042

Financial information for each of the Company s geographic areas is presented in the following table. Long-lived assets are those assets that are identified within the operations in each geographic area, including property, plant, equipment, goodwill, intangibles, and other assets.

	Three Months Ended September 30,		Six Months Ended September 30,	
	2006	2005	2006	2005
Revenues:				
United States	$ 224,219	$ 221,326	$ 435,181	$ 439,868
International	59,317	52,110	113,422	101,651

Total revenues	$ 283,536	$ 273,436	$ 548,603	$ 541,519

	September 30, 2006	March 31, 2006
Long-lived assets:		
United States	$ 582,638	$ 589,384
International	144,279	139,274
Total long-lived assets	$ 726,917	$ 728,658

14. Repurchases of Common Shares

On July 27, 2006, the Company announced that its Board of Directors had authorized the Company to repurchase up to 3,000,000 of its common shares, replacing a previous authorization to repurchase up to 3,000,000 shares under which 10,900 shares remained available for repurchase. This share repurchase authorization does not have a stated maturity date.

STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

September 30, 2006 and 2005

(dollars in thousands, except per share amounts)

During the first half of fiscal 2007, the Company repurchased 2,585,300 of its common shares for $59,628, representing an average price of $23.06 per common share. At September 30, 2006, 2,617,300 common shares remained authorized for repurchase and 5,415,895 common shares were held in treasury.

15. Financial and Other Guarantees

The Company generally offers a limited parts and labor warranty on its capital equipment. The specific terms and conditions of those warranties vary depending on the product sold and the country where the Company conducts business. The Company provides for the estimated cost of product warranties at the time product revenues are recognized. Amounts due to customers for the Company s future performance under these warranties are recorded as a current liability on the accompanying Consolidated Balance Sheets within Accrued expenses and other. Factors that affect the Company s warranty liability include the number and type of installed units, historical and anticipated rates of product failures, and material and service costs per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

Changes in the Company s warranty liability during the first half of fiscal 2007 were as follows:

Balance, March 31, 2006	$ 7,226
Warranties issued during the period	3,559
Settlements made during the period	(5,060)
Balance, September 30, 2006	$ 5,725

The Company also issues product maintenance contracts to its customers that are accounted for in accordance with the requirements of FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts. Such contracts generally range in terms from one to five years and require the Company to maintain and repair capital products over the maintenance contract term. Amounts due from customers under these contracts are initially recorded as a liability for deferred service contract revenue on the accompanying Consolidated Balance Sheets. The liability recorded for such deferred service revenue was $17,302 and $15,876 as of September 30, 2006 and March 31, 2006, respectively. Such deferred revenues are then amortized on a straight-line basis over the contract term and recognized as service revenues on the accompanying Consolidated Statements of Income. The activity related to the liability for deferred service contract revenues has been excluded from the table presented above.

16. Foreign Currency Forward Contracts

The Company enters into forward contracts to hedge potential foreign currency gains and losses that arise from assets and liabilities denominated in foreign currencies, including inter-company transactions. The Company does not use derivative financial instruments for speculative purposes. These contracts are marked to market, with gains and losses recognized on the accompanying Consolidated Statements of Income within Selling, general, and administrative expenses. At September 30, 2006, the Company held foreign currency forward contracts to sell euro and Canadian dollars 12.0 million and 3.0 million, respectively, and to buy Canadian dollars 3.0 million.

17. Business Acquisitions

Pursuant to the terms of the share purchase agreement with respect to Hamo Holding AG (Hamo), the final settlement and resolution of certain indemnification claims was made during the first quarter of fiscal 2006.

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STERIS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) (Continued)

For the Three and Six Months Ended

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(dollars in thousands, except per share amounts)

Amounts received by the Company amounted to approximately 2.2 million Swiss francs (approximately $1,700) and are included in Interest and miscellaneous income on the Consolidated Statements of Income. Hamo was acquired by the Company during fiscal 2004.

18. Business Dispositions

On October 31, 2005, the Company completed the sale of its freeze dryer (lyophilizer) product line to GEA Group of Germany for 20.8 million euros (approximately $25,161). The transaction resulted in an after-tax gain to the Company of $6,861 ($627 recognized in the first half of fiscal 2007 and $6,234 recognized in fiscal 2006). The gain recognized is preliminary because the purchase price is subject to post-closing adjustments. In addition, the Company granted certain indemnifications to the buyer related to potential claims in the areas of income taxes and environmental issues, which expire at various points in the future. The freeze dryer product line, based in Cologne, Germany, was part of the Company s Life Sciences segment. Goodwill of $5,571 was allocated to the freeze dryer product line in connection with its disposition. This product line is presented in the Company s financial statements as a discontinued operation. All historical financial information for this product line has been classified as a discontinued operation. Segment results for the three and six months ended September 30, 2005 exclude the freeze dryer product line and reflect the reallocation of corporate overhead charges to all business segments. Revenues, income before income taxes, income tax expense, and net income generated by this discontinued operation prior to its disposition were as follows:

(dollars in thousands)	Three Months Ended September 30, 2005	Six Months Ended September 30, 2005
Revenues	$ 10,934	$ 19,549
Income before income taxes	1,609	2,256
Income tax expense	599	846
Income from discontinued operations	$ 1,010	$ 1,410

19. Subsequent Events

Subsequent to September 30, 2006, foreign currency contracts to sell euro and Canadian dollars 12.0 million and 3.0 million, respectively, and to buy Canadian dollars 3.0 million matured. Subsequent to September 30, 2006, the Company entered into foreign currency forward contracts to sell euro 8.0 million and buy British pounds 2.0 million.

On October 25, 2006, the Company announced that its Board of Directors had declared a quarterly cash dividend in the amount of $0.05 per common share, payable on December 13, 2006, to shareholders of record as of November 15, 2006.

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Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders

STERIS Corporation

We have reviewed the consolidated balance sheet of STERIS Corporation and subsidiaries as of September 30, 2006, and the related consolidated statements of income and cash flows for the three-month and six-month periods ended September 30, 2006 and 2005. These financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based upon our review, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of STERIS Corporation and subsidiaries as of March 31, 2006 and the related consolidated statements of income, shareholders equity and cash flows for the year then ended, not presented herein, and in our report dated June 8, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of March 31, 2006, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Ernst & Young LLP

Cleveland, Ohio

November 3, 2006

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Financial Measures. In the following sections of Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A), the Company, at times, may refer to financial measures that are not required to be presented in the consolidated financial statements under accounting principles generally accepted in the United States. The Company has used the following financial measures that are not required to be presented under accounting principles generally accepted in the United States in the context of this report: backlog, debt to capital, and days sales outstanding. The Company defines these financial measures as follows:

Backlog - is defined by the Company as the amount of unfilled capital purchase orders at a point in time. The Company uses this figure as a measure to assist in the projection of short-term financial results and inventory requirements.

Debt to capital - is defined by the Company as total debt divided by the sum of total debt and shareholders equity. The Company uses this figure as a financial liquidity measure to gauge its ability to borrow, provide strength/protection against creditors, fund growth, develop outside of its current business operations, and measure the risk of the Company s financial structure.

Days sales outstanding (DSOs) - is defined by the Company as the average collection period for sales revenues. It is calculated as net accounts receivable divided by the trailing four quarter s revenues, multiplied by 365. The Company uses this figure to help gauge the quality of its accounts receivable and expected time to collect.

In the following sections of MD&A, the Company, at times, may also refer to financial measures which are considered to be non-GAAP financial measures under the rules of the SEC. Non-GAAP financial measures used by the Company are as follows:

Free cash flow - is defined by the Company as net cash flows (used in) provided by operating activities as presented in the Consolidated Statements of Cash Flows less purchases of property, plant, equipment, and intangibles, net, which is also presented in the Consolidated Statements of Cash Flows. The Company uses this measure to gauge its ability to fund future growth opportunities, repurchase common shares, and pay cash dividends. The following table reconciles the calculations of the Company s free cash flow for the six months ended September 30, 2006 and 2005:

	Six Months Ended September 30,	
(dollars in thousands)	**2006**	**2005**
Cash flows from operating activities	$ 18,260	$ 85,651
Purchases of property, plant, equipment and intangibles, net	(21,419)	(22,737)
Free cash flow	$ (3,159)	$ 62,914

The Company, at times, may refer to its results of operations excluding certain transactions or amounts that are non-recurring or are not indicative of future results, in order to provide meaningful comparative analysis between the periods presented. For example, when discussing changes in revenues, the Company may, at times, exclude the impact of recently completed acquisitions and divestitures.

The Company has presented these financial measures because it believes that meaningful analysis of its financial performance is enhanced by an understanding of certain additional factors underlying that performance. These financial measures should not be considered alternatives to measures required by U.S. GAAP. The Company s calculations of these measures may differ from calculations of similar measures used by other companies.

Revenues - Defined. As required by Regulation S-X, the Company has presented separately on its Consolidated Statements of Income, for each period presented, revenues generated as either product revenues or

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service revenues. In discussing revenues, the Company, at times, may refer to revenues in differing detail than that which is required by Regulation S-X. The terminology, definitions, and applications of terms that the Company uses to describe revenues may differ from terms used by other companies. The Company uses the following terms to describe revenues:

Revenues - The Company s revenues are presented net of sales returns and allowances.

Product Revenues - Product revenues are defined by the Company as revenues generated from sales of capital equipment, which includes steam and low temperature liquid sterilizers, washing systems, VHP® technology, water stills, and pure steam generators; surgical lights, tables and ceiling management systems; and the consumable family of products, which includes STERIS SYSTEM 1® consumables, sterility assurance products, skin care products, and cleaning consumables.

Service Revenues - Service revenues are defined by the Company as revenues generated from parts and labor associated with the maintenance, repair, and installation of capital equipment, as well as revenues generated from contract sterilization offered through the Company s Isomedix Services segment.

Capital Revenues - Capital revenues, a subset of product revenues, are defined by the Company as revenues generated from sales of capital equipment, which includes steam and low temperature liquid sterilizers, washing systems, VHP® technology, water stills, and pure steam generators; and surgical lights, tables and ceiling management systems.

Consumable Revenues - Consumable revenues, a subset of product revenues, are defined by the Company as revenues generated from sales of the consumable family of products, which includes STERIS SYSTEM 1® consumables, sterility assurance products, skin care products, and cleaning consumables.

Recurring Revenues - Recurring revenues are defined by the Company as consumable revenues and service revenues.

General Company Overview and Executive Summary. The mission of STERIS Corporation is to provide a healthier today and safer tomorrow through knowledgeable people and innovative infection prevention, decontamination and health science technologies, products, and services. The Company s dedicated employees around the world work together to supply a broad range of solutions by offering a combination of equipment, consumables, and services to healthcare, pharmaceutical, industrial, and governmental customers.

The Company s revenues are primarily derived from the healthcare and pharmaceutical industries. Much of the growth in its markets is driven by the aging of the population throughout the world, as an increasing number of individuals are entering their prime healthcare consumption years. In addition, each of STERIS s core industries also are benefiting from specific trends that drive growth. Within the healthcare market, there is increased concern regarding the level of hospital-acquired infections around the world. The pharmaceutical industry has been impacted by increased FDA scrutiny of cleaning and validation processes, mandating that manufacturers improve their processes. In the contract sterilization industry, where Isomedix competes, a trend toward the outsourcing of sterilization services continues to drive growth.

Beyond STERIS s core markets, infection-control issues are becoming a global concern, and emerging threats have gained prominence in the news. Through STERIS s Life Sciences segment, the Company is actively pursuing new opportunities to adapt its proven technologies to meet the needs of emerging applications such as defense, aerospace, and industrial decontamination. As a result of these efforts, the Company recently announced the grant of United States Environmental Protection Agency label clearance which will allow for the more universal application of its proprietary technologies to combat emerging decontamination needs in various environments.

On January 30, 2006, the Company announced that the manufacturing portion of its Erie, Pennsylvania operations will be transferred to Mexico to reduce production costs and improve the Company s competitive

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position. Plans for other restructuring actions designed to reduce operating costs within the ongoing operations of both the Healthcare and Life Sciences segments also were approved.

During the first half of fiscal 2007, the Company incurred pre-tax expenses of $5.7 million associated with the transfer of its Erie, Pennsylvania manufacturing operations to Monterrey, Mexico. Included in these expenses are $2.3 million classified as restructuring expenses, primarily related to accelerated depreciation of assets, compensation and severance and termination benefits related to the transition.

Fiscal 2007 second quarter and first half revenues were $283.5 million and $548.6 million, respectively, representing increases of 3.7% and 1.3%, respectively, from the same prior year periods. Revenue growth in the second quarter was primarily driven by increases in the Life Sciences and Isomedix Services segments, with only a marginal increase in the Healthcare segment s revenues. Revenue growth for the first half of fiscal 2007 reflects increases in all three business segments.

The Company s gross margin percentages were 41.9% and 42.3% for the second quarter and first half of fiscal 2007, representing increases of 50 basis points and 10 basis points, respectively, from the same prior year periods. Gross margins during both fiscal 2007 periods were positively impacted, as price increases and productivity improvements more than offset increases in the costs of labor and materials.

Free cash flow was negative $3.2 million in the first half of fiscal 2007 compared to $62.9 million in the prior year first half. The fiscal 2007 first half negative free cash flow of $3.2 million was a result of working capital changes, including approximately $30.0 million in payments to the IRS for taxes previously recognized and higher inventory levels. The Company s debt-to-capital ratio increased to 17.2% at September 30, 2006 from 13.7% at March 31, 2006 reflecting increased borrowings utilized to fund working capital changes and common share repurchases. During the first half of fiscal 2007, the Company repurchased approximately 2.6 million common shares at an average purchase price per share of $23.06. The Company also declared and paid quarterly cash dividends of $0.08 per common share in each of the first half of fiscal 2007 and fiscal 2006.

On October 25, 2006, the Company announced that its Board of Directors increased its quarterly cash dividend by 25% and declared a quarterly cash dividend in the amount of $0.05 per common share, payable on December 13, 2006, to shareholders of record as of November 15, 2006.

Additional information regarding the Company s fiscal 2007 second quarter and first half financial performance is included in the subsection below titled Results of Operations.

Matters Affecting Comparability.

Accounting for Share-Based Compensation. On April 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS No. 123R), Share-Based Payment, using the modified prospective transition method. SFAS No. 123R requires the Company to estimate the fair value of share-based awards on the date of the grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company s consolidated statements of income.

The Company s consolidated financial statements as of September 30, 2006 and for the three and six month periods then ended reflect the impact of SFAS No. 123R. In accordance with the modified prospective transition method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include the impact of SFAS No. 123R. Total share-based compensation expense for the second quarter and first half of fiscal 2007 was $3.7 million and $5.8 million, respectively, on a pre-tax basis, or $2.3 million ($0.03 per basic and diluted share) and $3.6 million, ($0.05 per basic and diluted share), net of tax.

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As of September 30, 2006, there was $14.8 million of total unrecognized compensation cost related to non-vested share-based compensation granted under the Company s stock option plans. The cost is expected to be recognized over a weighted average period of 1.21 years.

Additional information regarding the Company s adoption of SFAS No. 123R is included in notes 1 and 2 to the consolidated financial statements.

Business Dispositions. On October 31, 2005, the Company completed the sale of its freeze dryer (lyophilizer) product line to GEA Group of Germany for 20.8 million euros (approximately $25.2 million). The transaction resulted in an after-tax gain to the Company of approximately $6.8 million ($0.6 million recognized in the first half of fiscal 2007 and $6.2 million recognized in fiscal 2006). The gain recognized remains subject to adjustment as transaction costs are finalized. The freeze dryer product line, based in Cologne, Germany, was part of the Company s Life Sciences segment. All historical financial information for this product line has been classified as a discontinued operation. Segment results for the three and six months ended September 30, 2005 exclude the freeze dryer product line and reflect the reallocation of corporate overhead charges to all business segments.

International Operations. Given the nature of the Company s global operations, it maintains an inherent exposure to fluctuations in foreign currencies. During the second quarter of fiscal 2007, the Company s revenues were favorably impacted by $2.1 million, or 0.8%, and income before taxes was unfavorably impacted by $0.8 million, or 3.3%, compared with the same period in fiscal 2006, as a result of foreign currency fluctuations. During the first half of fiscal 2007, the Company s revenues were favorably impacted by $3.4 million, or 0.6%, and income before taxes was favorably impacted by $1.7 million, or 3.7%, as compared to the same prior year period, as a result of foreign currency fluctuations.

Results of Operations. The following subsections provide information regarding the Company s results of operations for the second quarter and first half of fiscal 2007 compared with the same fiscal 2006 periods.

Revenues. The following table contains information regarding the Company s revenues for the second quarter and first half of fiscal 2007 and 2006:

	Three Months Ended September 30,			Percent	Percent of Total Revenues	
(dollars in thousands)	**2006**	**2005**	**Change**	**Change**	**2006 (1)**	**2005 (1)**
Capital Revenues	$ 115,104	$ 113,098	$ 2,006	1.8%	40.6%	41.4%
Consumable Revenues	64,271	61,748	2,523	4.1%	22.7%	22.6%
Product Revenues	179,375	174,846	4,529	2.6%	63.3%	63.9%
Service Revenues	104,161	98,590	5,571	5.7%	36.7%	36.1%
Total Revenues	$ 283,536	$ 273,436	$ 10,100	3.7%	100.0%	100.0%
Service Revenues	$ 104,161	$ 98,590	$ 5,571	5.7%	36.7%	36.1%
Consumable Revenues	64,271	61,748	2,523	4.1%	22.7%	22.6%

Recurring Revenues	168,432	160,338	8,094	5.0%	59.4%	58.6%
Capital Revenues	115,104	113,098	2,006	1.8%	40.6%	41.4%
Total Revenues	$ 283,536	$ 273,436	$ 10,100	3.7%	100.0%	100.0%
United States	$ 224,219	$ 221,326	$ 2,893	1.3%	79.1%	80.9%
International	59,317	52,110	7,207	13.8%	20.9%	19.1%
Total Revenues	$ 283,536	$ 273,436	$ 10,100	3.7%	100.0%	100.0%

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(dollars in thousands)	Six Months Ended September 30, 2006	2005	Change	Percent Change	Percent of Total Revenues 2006 (1)	2005 (1)
Capital Revenues	$ 215,157	$ 216,074	$ (917)	-0.4%	39.2%	39.9%
Consumable Revenues	129,977	127,918	2,059	1.6%	23.7%	23.6%
Product Revenues	345,134	343,992	1,142	0.3%	62.9%	63.5%
Service Revenues	203,469	197,527	5,942	3.0%	37.1%	36.5%
Total Revenues	$ 548,603	$ 541,519	$ 7,084	1.3%	100.0%	100.0%
Service Revenues	$ 203,469	$ 197,527	$ 5,942	3.0%	37.1%	36.5%
Consumable Revenues	129,977	127,918	2,059	1.6%	23.7%	23.6%
Recurring Revenues	333,446	325,445	8,001	2.5%	60.8%	60.1%
Capital Revenues	215,157	216,074	(917)	-0.4%	39.2%	39.9%
Total Revenues	$ 548,603	$ 541,519	$ 7,084	1.3%	100.0%	100.0%
United States	$ 435,181	$ 439,868	$ (4,687)	-1.1%	79.3%	81.2%
International	113,422	101,651	11,771	11.6%	20.7%	18.8%
Total Revenues	$ 548,603	$ 541,519	$ 7,084	1.3%	100.0%	100.0%

(1) Certain percentages may not calculate precisely due to rounding.

Quarter over Quarter Comparison

Revenues increased $10.1 million, or 3.7%, to $283.5 million for the quarter ended September 30, 2006, as compared to $273.4 million for the comparable prior year quarter. As compared to the second quarter of fiscal 2006, recurring revenues increased 5.0%, driven by increases in consumable revenues and service revenues of 4.1% and 5.7%, respectively. Capital revenues increased $2.0 million quarter over quarter as revenues increased internationally to more than offset a decline in the United States.

International revenues increased $7.2 million, or 13.8%, to $59.3 million, for the quarter ended September 30, 2006, as compared to $52.1 million for the comparable prior year quarter. International revenues were positively impacted by capital equipment revenues growth within both the Healthcare and Life Sciences segments with increases of 8.0% and 31.9%, respectively, over the comparable prior year quarter. Recurring revenues also grew within both the Healthcare and Life Sciences segments with increases of 7.9% and 27.6%, respectively, over the comparable prior year quarter.

United States revenues increased $2.9 million, or 1.3%, to $224.2 million, for the quarter ended September 30, 2006, as compared to $221.3 million for the comparable prior year quarter. United States revenues were positively impacted by recurring revenue growth in all three business segments with increases of 3.3%, 4.9%, and 3.5% in the Healthcare, Life Sciences, and Isomedix segments, respectively. The strength in recurring revenues was partially offset by a decline in capital revenues for the Healthcare segment of 3.7%. Strong demand for surgical and critical care products within the Healthcare segment was offset by lower than anticipated shipments of high temperature sterilization equipment in the United States.

Year over Year Comparison

Revenues increased $7.1 million, or 1.3%, to $548.6 million for the first half of fiscal 2007, as compared to $541.5 million during the first half of fiscal 2006. As compared to the first half of fiscal 2006, recurring revenues increased 2.5%, reflecting growth in consumables revenues and service revenues, with increases of 1.6% and 3.0%, respectively. Capital revenues were relatively flat, with a decline of 0.4%.

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International revenues for the first half of fiscal 2007 amounted to $113.4 million, an increase of $11.8 million, or 11.6%, as compared to the first half of fiscal 2006. Fiscal 2007 year-to-date international revenues were positively impacted by strong capital revenue growth within both the Healthcare and Life Sciences segments, with increases of 15.4% and 30.2%, respectively.

United States revenues for the first half of fiscal 2007 amounted to $435.2 million, a decrease of $4.7 million, or 1.1%, as compared to the first half of fiscal 2006. Strong underlying demand for the Company s service offerings and consumable products was offset by a decline in capital revenues in both the Healthcare and Life Sciences segments.

Revenues are further discussed on a segment basis in the section of MD&A titled, Business Segment Results of Operations.

Gross Profit. The following table contains information regarding the Company s gross profit for the three and six months ended September 30, 2006 and 2005:

(dollars in thousands)	**Three Months Ended September 30, 2006**	**2005**	**Change**	**Percent Change**
Gross Profit:				
Product	$ 73,028	$ 71,421	$ 1,607	2.3%
Service	45,733	41,762	3,971	9.5%
Total Gross Profit	$ 118,761	$ 113,183	$ 5,578	4.9%
Gross Profit Percentage:				
Product	40.7%	40.8%		
Service	43.9%	42.4%		
Total Gross Profit Percentage	41.9%	41.4%		

	Six Months Ended September 30, 2006	**2005**	**Change**	**Percent Change**
Gross Profit:				
Product	$ 143,494	$ 144,607	$ (1,113)	-0.8%
Service	88,642	84,152	4,490	5.3%
Total Gross Profit	$ 232,136	$ 228,759	$ 3,377	1.5%
Gross Profit Percentage:				
Product	41.6%			