

**1-800-PetMeds<sup>®</sup>**  
America's Largest Pet Pharmacy

**2006 ANNUAL REPORT**



*- Focusing on our customers and the health of their pets -*

**PetMed Express, Inc.**

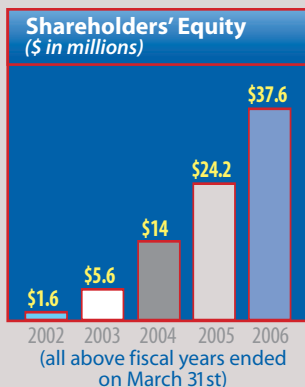
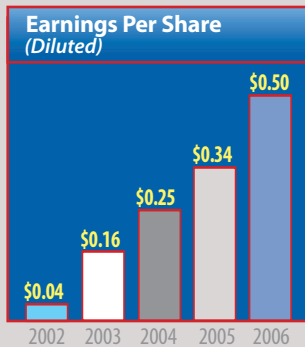
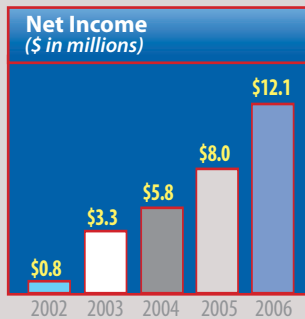
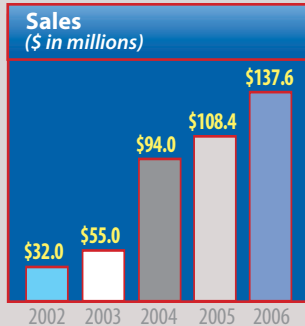


# 1-800-PetMeds®

America's Largest Pet Pharmacy

## - To My Fellow Stockholders -

### PERFORMANCE SUMMARY



PetMed Express, Inc., America's Largest Pet Pharmacy, has served over two million customers since our inception. Over the past five years we have invested approximately \$87.7 million in our advertising campaigns to establish and sustain our "1-800-PetMeds" brand name. This investment has enabled us to increase our sales from \$10.0 million in March 2001 to \$137.6 million in March 2006, a compounded annual growth rate of 69%.

We are proud to report that for the fiscal year ended March 31, 2006, net income grew to \$12.1 million or \$0.50 diluted per share, compared to net income of \$8.0 million or \$0.34 diluted per share for fiscal 2005, an increase to net income of 51%. Net sales for fiscal 2006 grew to \$137.6 million, compared to \$108.4 million for fiscal 2005, an increase of 27%. We are also pleased to report that our reorder sales increased 29%, from \$68.7 million to \$88.4 million for fiscal 2005 and 2006, respectively.

One of our primary goals in fiscal 2007 will be to continue to improve our reorders sales with ongoing personalized communication, including educational content, solution centers like the newly launched website "PetHealth101" which we sponsor, and other wellness programs. Approximately 1.6 million of our customers have placed an order with us over the past two years.

At 1-800-PetMeds, our focus has always been and will continue to be on our customers and the health of their pets. In the United States, pets are treated as part of the family, and our customers continue to want the best for their pets. We are committed to our customers as we constantly strive to provide them with superior service and support. Our motto is "Do whatever it takes to make the customer happy!"

With our "1-800-PetMeds" brand name, our quality customer care and support, and our state-of-the-art fulfillment center and pharmacy, we are strategically positioned to continue to capture market share as the demand for the on-line/direct mail distribution channel continues to grow. As in years past, we thank our customers, employees, and stockholders for their ongoing support and loyalty, as we continue toward our goal of building and increasing the value of our Company.

Sincerely,

Menderes Akdag  
Chief Executive Officer, President and Director  
June 23, 2006

**PetMed Express, Inc.**

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

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

For the fiscal year ended March 31, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-28827

**PETMED EXPRESS, INC.**

(Exact name of Registrant as specified in its charter)

**FLORIDA**  
(State or other jurisdiction of  
incorporation or organization)

**65-0680967**  
(IRS Employer  
Identification No.)

**1441 S.W. 29<sup>th</sup> Avenue, Pompano Beach, Florida 33069**  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (954) 979-5995

Securities registered under Section 12(b) of the Act:

Title of each class

Name of each exchange on which registered

NONE

Securities registered under Section 12(g) of the Act:

**COMMON STOCK, \$.001 PAR VALUE**

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

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The aggregate market value of the common stock held by non-affiliates of the registrant as of September 30, 2005, the last business day of the registrant's most recently completed second fiscal quarter, was \$194,674,000 based on the closing sales price for the Registrant's Common Stock on that date.

The number of shares of the Registrant's Common Stock outstanding as of May 31, 2006 was 24,007,390.

**DOCUMENTS INCORPORATED BY REFERENCE**

**Information to be set forth in our Proxy Statement relating to our 2006 Annual Meeting of Stockholders to be held on July 28, 2006 is incorporated by reference in Items 10, 11, 12, 13, and 14 of Part III of this report.**

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# PETMED EXPRESS, INC.

2006 Annual Report on Form 10-K

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## PART I

### CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Certain information in this Annual Report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. You can identify these forward-looking statements by the words "believes," "intends," "expects," "may," "will," "should," "plan," "projects," "contemplates," "intends," "budgets," "predicts," "estimates," "anticipates," or similar expressions. These statements are based on our beliefs, as well as assumptions we have used based upon information currently available to us. Because these statements reflect our current views concerning future events, these statements involve risks, uncertainties and assumptions. Actual future results may differ significantly from the results discussed in the forward-looking statements. A reader, whether investing in our common stock or not, should not place undue reliance on these forward-looking statements, which apply only as of the date of this Annual Report.

When used in this Annual Report on Form 10-K, "PetMed Express," "1-800-PetMeds," "PetMed," "PetMed Express.com," "the Company," "we," "our," and "us" refer to PetMed Express, Inc. and our subsidiaries.

### ITEM 1. BUSINESS

#### General

PetMed Express, Inc. and subsidiaries, d/b/a 1-800-PetMeds, is a leading nationwide pet pharmacy. The Company markets prescription and non-prescription pet medications, and other health products for dogs, cats, and horses direct to the consumer. The Company offers consumers an attractive alternative for obtaining pet medications in terms of convenience, price, and speed of delivery.

The Company markets its products through national television, online and direct mail/print advertising campaigns, which aim to increase the recognition of the "1-800-PetMeds" brand name, increase traffic on its website at [www.1800petmeds.com](http://www.1800petmeds.com), acquire new customers, and maximize repeat purchases. Our fiscal year end is March 31, our executive offices are located at 1441 S.W. 29<sup>th</sup> Avenue, Pompano Beach, Florida 33069, and our telephone number is (954) 979-5995. The information contained on the Company's website is not part of our Annual Report.

#### Our Products

We offer a broad selection of products for dogs, cats and horses. These products include a majority of the well-known brands of medication, such as Frontline Plus®, K9 Advantix®, Advantage®, Heartgard Plus®, Sentinel®, Interceptor®, Program®, Revolution®, Deramaxx® and Rimadyl®. Generally, our prices are competitive with the prices for medications charged by veterinarians and retailers.

We research new products, and regularly select new products or the latest generation of existing products to become part of our product selection. In addition, we also refine our current products to respond to changing consumer-purchasing habits. Our website is designed to give us the flexibility to change featured products or promotions. Our product line provides customers with a wide variety of selections across the most popular health categories for dogs, cats and horses. Our current products include:

*Non-Prescription Medications (OTC):* Flea and tick control products, bone and joint care products, vitamins and nutritional supplements, and hygiene products.

*Prescription Medications (Rx):* Heartworm treatments, thyroid and arthritis medications, antibiotics, and other specialty medications, as well as generic substitutes.

## Sales

The following table provides a breakdown of the percentage of our total sales by each category during the indicated periods:

|   | Year Ended March 31, |      |      |
|---|----------------------|------|------|
|   | 2006                 | 2005 | 2004 |
| Non-prescription medications            | 70%                  | 69%  | 69%  |
| Prescription medications                | 29%                  | 30%  | 30%  |
| Shipping and handling charges and other | 1%                   | 1%   | 1%   |
| Total                                   | 100%                 | 100% | 100% |

We offer our products through three main sales channels: Internet, through our website, telephone contact center, through our toll-free number, and direct mail/print, through the 1-800-PetMeds catalog and postcards. We have designed both our catalog and website to provide a convenient, cost-effective and informative shopping experience that encourages consumers to purchase products important for a pet's health and quality of life. We believe that these multiple channels allow us to increase the visibility of our brand name and provide customers with increased shopping flexibility and service.

### *Internet*

We seek to combine our product selection and pet health information with the shopping ease of the Internet to deliver a convenient and personalized shopping experience. Our website offers health and nutritional product selections for dogs, cats and horses, and relevant editorial and easily obtainable or retrievable resource information. From our home page, customers can search our website for products and access resources on a variety of information on dogs, cats and horses. Customers can shop at our website by category, product line or individual product. We attracted approximately 10.7 million visitors to our website during the fiscal 2006, approximately 11% of those visitors placed an order, and our website generated approximately 57% of our total sales for the same time period.

In February 2006 the Company introduced a new website, called, "Pet Health 101" which is located at [www.PetHealth101.com](http://www.PetHealth101.com). In Pet Health 101, you have access to health information covering pet's behavior and illnesses—and to the natural and pharmaceutical remedies specifically for your pet's problems. Pet Health 101 is updated with the latest research for pet owners.

### *Telephone Contact Center*

We currently employ 113 customer care representatives in our contact center. Our customer care representatives receive and process inbound customer calls, facilitate our outbound campaigns around maximizing customers' reorders, facilitate our live web chat and process customer e-mails. Our telephone system is equipped with certain features including pop-up screens and call blending capabilities that give us the ability to efficiently utilize our customer care representatives' time, providing quality customer care and service and support. Our customer care representatives receive a base salary and are rewarded with commissions for sales.

### *Direct Mail/Print*

The 1-800-PetMeds catalog is a full-color catalog that features our most popular products. The catalog is produced by a combination of in-house writers, production artists and independent contractors. We mail catalogs and postcards in response to requests generated from our advertising and as part of direct mail campaigns.

## **Our Customers**

Approximately 1,600,000 customers have purchased from us within the last two years. We attracted approximately 624,000 and 510,000 new customers in fiscal 2006 and 2005, respectively. Our customers are located throughout the United States, with approximately 51% of customers residing in California, Florida, New York, Texas, Pennsylvania, New Jersey, and Georgia. The average retail purchase was approximately \$77.

While our primary focus has been on retail customers, we have also sold various non-prescription medications wholesale to a variety of businesses, including pet stores, groomers and traditional retailers in the United States. For the fiscal year ended March 31, 2006, the majority of our sales were made to retail customers with approximately 3% of our sales made to wholesale customers.

## **Marketing**

The goal of our marketing strategy is to build brand recognition, increase customer traffic, add new customers, build strong customer loyalty, maximize reorders and develop incremental revenue opportunities. We have an integrated marketing campaign that includes television advertising, direct mail/print and e-mail, and online marketing.

### *Television Advertising*

Our television advertising is designed to build brand equity, create awareness, and generate initial purchases of products via the telephone and the Internet. We have used :30 and :15 second television commercials to attract new customer orders, with the tagline “the 1-800-PetMeds difference, great savings, fast service, free shipping.” Our television commercials typically focus on our ability to rapidly deliver to customers the same medications offered by veterinarians, but at reduced prices. We generally purchase advertising on national cable channels to target our key demographic groups. We believe that television advertising is particularly effective and instrumental in building brand awareness.

### *Direct Mail/Print and E-mail*

We use direct mail/print and e-mail to acquire new customers and to remind our existing customers to reorder.

### *Online Marketing*

We supplement our traditional advertising with online advertising and marketing efforts. We are members of the LinkShare Network, which is an affiliate program with merchant clients and affiliate websites. This network is designed to develop and build a long-term, branded affiliate program in order to increase online sales and establish an Internet presence. The LinkShare Network enables us to establish link arrangements with other websites, as well as with portals and search engines. We also make our brand available to internet consumers by purchasing targeted keywords and achieving prominent placement on the top search engines and search engine networks, including Google, Microsoft Network, and Yahoo.

## **Operations**

### *Purchasing*

We purchase our products from a variety of sources, including certain manufacturers, domestic distributors, and wholesalers. We have multiple suppliers for each of our products to obtain the lowest cost. We purchase the majority of our health and nutritional supplements directly from manufacturers. Having strong relationships with product manufacturers will ensure the availability of adequate volume of products ordered by our customers, and will enable us to provide more and better product information. Historically, substantially all the major manufacturers of prescription and non-prescription medications have declined to sell these products to direct marketing companies. (See Risk Factors.) Part of our growth strategy includes developing direct relationships with the leading pharmaceutical manufacturers of the more popular prescription and non-prescription medications.

### *Order Processing*

The Company provides its customers with toll-free telephone access to its customer care representatives. Our call center generally operates from 8:00 AM to 11:00 PM Monday through Thursday, 8:00 AM to 9:00 PM on Friday, 9:00 AM to 6:00 PM on Saturday, and 10:00 AM to 5:00 PM on Sunday, Eastern Standard Time. The process of customers purchasing products from 1-800-PetMeds consists of a few simple steps. A customer first places a call to our toll-free telephone number or visits our website. The following information is needed to process prescription orders: general pet information, prescription, and the veterinarian’s name and phone number. This information is entered into our computer system. Then our pharmacists and pharmacy technicians verify all prescriptions. The order process system checks for the verification for prescription medication orders and a valid payment method for all orders. An invoice is generated and printed in our fulfillment center, where items are picked for shipping. The customer’s order is then selected from the Company’s inventory and shipped via United States Priority Mail, United Parcel Service, or Federal Express. Our customers enjoy the convenience of rapid home delivery, with approximately 71% of all orders being shipped within 24 hours of ordering. Our website allows customers to easily browse and purchase substantially all of our products online. Our website is designed to be fast, secure and easy to use with order and shipping confirmations, and with online order tracking capabilities.

### *Warehousing and Shipping*

We inventory our products and fill all customer orders from our 50,000 square foot facility in Pompano Beach, Florida. We have an in-house fulfillment and distribution operation, which is used to manage the entire supply chain, beginning with the placement of the order, continuing through order processing, and then fulfilling and shipping of the product to the customer. We offer a variety of shipping options, including next day delivery. We ship to anywhere in the United States served by the United States Postal Service, United Parcel Service, and Federal Express. Priority orders are expedited in our fulfillment process. Our goal is to ship the products the same day that the order is received. For prescription medications, our goal is to ship the product immediately after the prescription has been authorized by the customer's veterinarian.

### *Customer Service and Support*

We believe that a high level of customer service and support is critical in retaining and expanding our customer base. Customer care representatives participate in ongoing training programs under the supervision of our training managers. These training sessions include a variety of topics such as product knowledge, computer usage, customer service tips and the relationship between PetMed Express and veterinarians. Our customer care representatives respond to customers' e-mails and calls that are related to order status, prices and shipping. Our customer care representatives also respond to customers through our live web chat. If our customer care representatives are unable to respond to a customer's inquiry at the time of the call, we strive to provide an answer within 24 hours. We believe our customer care representatives are a valuable source of feedback regarding customer satisfaction. Our customer returns and credits average approximately 1.5% of total sales.

### **Technology**

PetMed Express utilizes integrated technologies in call center, e-commerce, order entry, and inventory control/fulfillment operations. Our systems are custom configured by the Company to optimize our computer telephone integration and mail order processing. The systems are designed to maintain a large database of specialized information and process a large volume of orders efficiently and effectively. Our systems provide our agents with real time product availability information and updated customer information to enhance our customer service. We also have an integrated direct connection for processing credit cards to ensure that a valid credit card number and authorization have been received at the same time our customer care representatives are on the phone with the customers or when customers submit an order on our website. Our information systems provide our customer care representatives with records of all prior contact with a customer, including the customer's address, phone number, e-mail address, fax number, prescription information, order history, payment history and notes.

### **Competition**

The pet medications market is competitive and highly fragmented. Our competitors consist of veterinarians, traditional retailers, and other mail-order and online retailers of pet medications and other health products. The Company believes that the following are the principal competitive factors in our market:

- Product selection and availability, including the availability of prescription and non-prescription medications;
- Brand recognition;
- Reliability and speed of delivery;
- Personalized service and convenience;
- Price; and
- Quality of website content.

We compete with veterinarians in the sale of prescription and non-prescription pet medications and other health products. Many pet owners may prefer the convenience of purchasing their pet medications or other health products at the time of the veterinarian visit, or may be hesitant to offend their veterinarian by not purchasing these products from the veterinarian. In order to effectively compete with veterinarians, we must continue to educate pet owners about the service, convenience and savings offered by PetMed Express.

According to the American Pet Products Manufacturers Association, pet spending in the United States increased 5.5% to \$36.3 billion in 2005. Pet supplies and medications represented \$8.7 billion, or 24% of the total pet spending in the United States. The pet medication market size is estimated to be approximately \$3 billion, with veterinarians having the majority of the market share. The dog and cat population is approximately 164 million, with approximately 63% of all households owning a pet.

The Company believes that the following are the main competitive strengths which differentiate 1-800-PetMeds from the competition:

- “1-800-PetMeds” brand name;
- Quality customer service and support;
- Consumer benefit structure of savings and convenience;
- Licensed pharmacy to conduct business in 49 states;
- Operating / technology infrastructure in place; and
- Multiple sources of supply for pet medications.

### **Intellectual Property**

We conduct our business under the trade name “1-800-PetMeds.” We believe this name, which is also our toll-free telephone number, has added significant value and is an important factor in the marketing of our products. We have also obtained the right to the Internet addresses [www.1800petmeds.com](http://www.1800petmeds.com), [www.1888petmeds.com](http://www.1888petmeds.com), [www.petmedexpress.com](http://www.petmedexpress.com), and [www.petmeds.com](http://www.petmeds.com). As with phone numbers, we do not have and cannot acquire any property rights in an Internet address. We do not expect to lose the ability to use the Internet addresses; however, there can be no assurance in this regard and the loss of these addresses may have a material adverse effect on our financial position and results of operations. We are the exclusive owners of United States Trademark Registrations for “PetMed Express®,” “1888PetMeds®” and “1-800-PetMeds®” and have a trademark application pending for “PetMeds.”

### **Government Regulation**

Dispensing prescription medications is governed at the state level by the Board of Pharmacy, or similar regulatory agencies, of each state where prescription medications are dispensed. We are subject to regulation by the State of Florida and are licensed by the Florida Board of Pharmacy. Our license is valid until February 28, 2007. We are also licensed and/or regulated by 48 other state pharmacy boards and other regulatory authorities including, but not necessarily limited to, the United States Food and Drug Administration (“FDA”) and the United States Environmental Protection Agency (“EPA”). As a licensed pharmacy in the State of Florida, we are subject to the Florida Pharmacy Act and regulations promulgated thereunder. To the extent that we are unable to maintain our license with the Florida Board of Pharmacy as a community pharmacy, or if we do not maintain the licenses granted by other state pharmacy boards, or if we become subject to actions by the FDA, or other enforcement regulators, our distribution of prescription medications to pet owners could cease, which could have a material adverse effect on our operations.

### **Employees**

The Company currently has 213 full time employees, including: 121 in sales, customer care and marketing; 28 in fulfillment and purchasing; 52 in our pharmacy; 3 in information technology; 3 in administrative positions; and 6 in management. None of the Company’s employees are represented by a labor union, or governed by any collective bargaining agreements. The Company considers relations with its employees as satisfactory.

### **ITEM 1A. RISK FACTORS**

You should carefully consider the risks and uncertainties described below, and all the other information included in this Annual Report before you decide to invest in our common stock. Any of the following risks could materially adversely affect our business, financial condition or operating results and could result in a loss of your investment.

*There can be no assurances that we can sustain profitable operations in future periods.*

We reported net income of \$12,064,000, \$8,010,000, and \$5,814,000 for the years ended March 31, 2006, 2005, and 2004, respectively. Our profitability during fiscal 2006 was due in part to increases in our reorder, new order and wholesale revenue and the leveraging of our general and administrative and advertising expenses. There are no assurances we will continue to generate revenues at this increased level, or that we will remain profitable during fiscal 2007 and beyond. If our operations were to cease being profitable, our liquidity in future periods would be adversely affected.

*We may fail to comply with various state regulations covering the dispensing of prescription pet medications. We could be subject to reprimands, sanctions, probations, fines, suspensions or the loss of one or more of our pharmacy licenses.*

The sale and delivery of prescription pet medications is generally governed by state laws and state regulations. Since our pharmacy is located in the State of Florida, the Company is governed by the laws and regulations of the State of Florida. Each prescription pet medication sale we make is likely to be covered by the laws of the state where the customer is located. The laws and regulations relating to the sale and delivery of prescription pet medications vary from state to state, but generally require that prescription pet medications be dispensed with the authorization from a prescribing veterinarian. To the extent that we are unable to maintain our license with the Florida Board of Pharmacy as a community pharmacy, or if we do not maintain the licenses granted by other state boards, or if we become subject to actions by the FDA, or other enforcement regulators, our distribution of prescription medications to pet owners could cease, which could have a material adverse effect on our operations.

While we make every effort to fully comply with the applicable state rules, laws and regulations, from time to time we have been the subject of administrative complaints regarding the authorization of prescriptions prior to shipment. We cannot assure you that we will not continue to be the subject of administrative complaints in the future. We cannot guarantee you that we will not be subject to reprimand, sanctions, probations, or fines, or that one or more of our pharmacy licenses may not be suspended or revoked. See Item 3. Legal Proceedings.

*We currently purchase a portion of our prescription and non-prescription medications from third party distributors and we are not an authorized distributor of these products. We do not have any guaranteed supply of these medications at any pre-established prices.*

For the fiscal years ended March 31, 2006 and 2005, the majority of our sales were attributable to sales of prescription and non-prescription medications. Historically, substantially all the major pharmaceutical manufacturers have declined to sell prescription and non-prescription pet medications directly to us. In order to assure a supply of these products, we purchase medications from various secondary sources, including a variety of domestic distributors. Our business strategy includes seeking to establish direct purchasing arrangements with major pet pharmaceutical manufacturing companies. If we are not successful in achieving this goal, we will continue to rely upon secondary sources.

We cannot guarantee that if we continue to purchase prescription and non-prescription pet medications from secondary sources that we will be able to purchase an adequate supply to meet our customers' demands, or that we will be able to purchase these products at competitive prices. As these products represent a significant portion of our sales, our failure to fill customer orders for these products could adversely impact our sales. If we are forced to pay higher prices for these products to ensure an adequate supply, we cannot guarantee that we will be able to pass along to our customers any increases in the prices we pay for these medications. This inability to pass along increased prices could materially adversely affect our financial condition and results of operations.

*Our failure to properly manage our inventory may result in excessive inventory carrying costs, which could materially adversely affect our financial condition and results of operations.*

Our current product line contains approximately 750 SKUs. A significant portion of our sales is attributable to products representing approximately 90 SKUs. We need to properly manage our inventory to provide an adequate supply of these products and avoid excessive inventory of the products representing the balance of the SKUs. We generally place orders for products with our suppliers based upon our internal estimates of the amounts of inventory we will need to fill future orders. These estimates may be significantly different from the actual orders we receive. In the event that subsequent orders fall short of original estimates, we may be left with excess inventory. Significant excess inventory could result in price discounts and increased inventory carrying costs. Similarly, if we fail to have an adequate supply of some SKUs, we may lose sales opportunities. We cannot guarantee that we will maintain appropriate inventory levels. Any failure on our part to maintain appropriate inventory levels may have a material adverse effect on our financial condition and results of operations.

*Resistance from veterinarians to authorize prescriptions could cause our sales to decrease and could materially adversely affect our financial condition and results of operations.*

Since we began our operations some veterinarians have resisted providing our customers with a copy of their pet's prescription or authorizing the prescription to our pharmacy staff, thereby effectively preventing us from filling such prescriptions under state law. Sales of prescription medications represented approximately 29% of our sales for the fiscal year. Although veterinarians in some states are required by law to provide the pet owner with this prescription information, if the number of veterinarians who refuse to authorize prescriptions should increase, our sales could decrease and our financial condition and results of operations may be materially adversely affected.

*Our success depends in part on the willingness of more consumers to purchase pet medications from us. If we do not succeed in changing consumer-purchasing patterns, our financial condition and results of operations may be materially adversely affected.*

The direct marketing of prescription and non-prescription pet medications and health and nutritional supplements is relatively new. Our success will depend upon our ability to engage consumers who have historically purchased pet medications and health and nutritional supplements from veterinarians. We may not be able to convert a large number of these pet owners to our customers. In order for us to be successful, many of these consumers must be willing to utilize new ways of buying these products. We cannot guarantee that we will be successful in shifting these consumer purchasing patterns away from veterinarians to us. If we do not attract consumers to purchase these products from us, our financial condition and results of operations may be materially adversely affected.

*Significant portions of our sales are made to residents of seven states. If we should lose our pharmacy license in one or more of these states, our financial condition and results of operations would be materially adversely affected.*

While we ship pet medications to customers in all 50 states, approximately 51% of our sales for the fiscal year ended March 31, 2006 were made to customers located in the states of California, Florida, New York, Texas, Pennsylvania, New Jersey, and Georgia. If for any reason our license to operate a pharmacy in one or more of those states should be suspended or revoked, or if it is not renewed, our financial condition and results of operations may be materially adversely affected.

*We face significant competition from veterinarians and traditional and online retailers and may not be able to profitably compete with them.*

We compete directly and indirectly with veterinarians for the sale of pet medications and other health products. Veterinarians hold a competitive advantage over us because many pet owners may find it more convenient or preferable to purchase these products directly from their veterinarians at the time of an office visit. We also compete directly and indirectly with both online and traditional retailers of pet medications and health and nutritional supplements. Both online and traditional retailers may hold a competitive advantage over us because of longer operating histories, established brand names, greater resources and an established customer base. Online retailers may have a competitive advantage over us because of established affiliate relationships to drive traffic to their website. Traditional retailers may hold a competitive advantage over us because pet owners may prefer to purchase these products from a store instead of online or through catalog or telephone methods. In order to effectively compete in the future, we may be required to offer promotions and other incentives, which may result in lower operating margins or adversely affect the results of operations.

We also face a significant challenge from our competitors forming alliances with each other, such as those between online and traditional retailers. These relationships may enable both their retail and online stores to negotiate better pricing and better terms from suppliers by aggregating the demand for products and negotiating volume discounts which could be a competitive disadvantage to us.

*The content of our website could expose us to various kinds of liability, which, if prosecuted successfully, could negatively impact our business.*

Because we post product information and other content on our website, we face potential liability for negligence, copyright infringement, patent infringement, trademark infringement, defamation and other claims based on the nature and content of the materials we post. Various claims have been brought, and sometimes successfully prosecuted, against Internet content distributors. We could be exposed to liability with respect to the unauthorized duplication of content or unauthorized use of other parties' proprietary technology. Although we maintain general liability insurance, our insurance may not cover potential claims of this type, or may not be adequate to indemnify us for all liability that may be imposed. Any imposition of liability that is not covered by insurance, or is in excess of insurance coverage, could materially adversely affect our financial condition and results of operations.

*We may not be able to protect our intellectual property rights, and we may be found to infringe on the proprietary rights of others.*

We rely on a combination of trademark, trade secret, copyright laws and contractual restrictions to protect our intellectual property rights. These afford only limited protection. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy our non-prescription private label generic equivalents, when and if developed, as well as aspects of our sales formats, or to obtain and use information that we regard as proprietary, including the technology used to operate our website, our content and our trademarks.

Litigation or proceedings before the United States Patent and Trademark Office may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets and domain names, and to determine the validity and scope of the proprietary rights of others. Any litigation or adverse priority proceeding could result in substantial costs and diversion of resources, and could seriously harm our business and operating results.

Third parties may also claim infringement by us with respect to past, current or future technologies. We expect that participants in our markets will be increasingly involved in infringement claims as the number of services and competitors in our industry segment grows. Any claim, whether meritorious or not, could be time consuming, result in costly litigation, cause service upgrade delays or require us to enter into royalty or licensing agreements. These royalty or licensing agreements might not be available on terms acceptable to us or at all.

*If we are unable to protect our Internet domain names or to prevent others from using names that are confusingly similar, our business may be adversely impacted.*

Our Internet domain names, [www.1800petmeds.com](http://www.1800petmeds.com), [www.1888petmeds.com](http://www.1888petmeds.com), [www.petmedexpress.com](http://www.petmedexpress.com), and [www.petmeds.com](http://www.petmeds.com) are critical to our brand recognition and our overall success. If we are unable to protect these domain names, our competitors could capitalize on our brand recognition. We are aware of substantially similar domain names, including [www.petmed.com](http://www.petmed.com), used by competitors. Governmental agencies and their designees generally regulate the acquisition and maintenance of domain names. The regulation of domain names in the United States and in foreign countries has changed, and may undergo further change in the near future. Furthermore, the relationship between regulations governing domain names and laws protecting trademarks and similar proprietary rights is unclear. Therefore, we may not be able to protect our own domain names, or prevent third parties from acquiring domain names that are confusingly similar to, infringe upon or otherwise decrease the value of our domain names.

*Since all of our operations are housed in a single location, we are more susceptible to business interruption in the event of damage to or disruptions in our facility.*

Our headquarters and distribution center are located in the same building in South Florida, and all of our shipments of products to our customers are made from this sole distribution center. We have no present plans to establish any additional distribution centers or offices. Because we consolidate our operations in one location, we are more susceptible to power and equipment failures, and business interruptions in the event of fires, floods and other natural disasters than if we had additional locations. Furthermore, because we are located in South Florida, which is a hurricane-sensitive area, we are particularly susceptible to the risk of damage to, or total destruction of, our headquarters and distribution center and surrounding transportation infrastructure caused by a hurricane. We cannot assure you that we are adequately insured to cover the amount of any losses relating to any of these potential events, business interruptions resulting from damage to or destruction of our headquarters and distribution center or power and equipment failures relating to our call center or websites; or interruptions or disruptions to major transportation infrastructure or other events that do not occur on our premises.

*A portion of our sales are seasonal and our operating results are difficult to predict and may fluctuate.*

Because our operating results are difficult to predict, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. The majority of our product sales are affected by the seasons, due to the seasonality of mainly heartworm and flea and tick medications. Seasonality trends are divided into percentage of sales by quarter. For the quarters ended June 30, 2005, September 30, 2005, December 31, 2005, and March 31, 2006 Company sales were 32%, 28%, 19%, and 21%, respectively.

In addition to the seasonality of our sales, our annual and quarterly operating results have fluctuated in the past and may fluctuate significantly in the future due to a variety of factors, many of which are out of our control. Factors that may cause our operating results to fluctuate include:

- Our ability to obtain new customers at a reasonable cost, retain existing customers, or encourage reorders;
- Our ability to increase the number of visitors to our website, or our ability to convert visitors to our website into customers;
- The mix of medications and other pet products sold by us;
- Our ability to manage inventory levels or obtaining an adequate supply of products;
- Our ability to adequately maintain, upgrade and develop our website, the systems that we use to process customers' orders and payments, or our computer network;
- Increased competition within our market niche;
- Price competition;
- Increases in the cost of advertising;

- The amount and timing of operating costs and capital expenditures relating to expansion of our product line or operations; and
- Disruption of our toll-free telephone service, technical difficulties, systems and Internet outages or slowdowns.

Any change in one or more of these factors could materially adversely affect our financial condition and results of operations in future periods.

*Our stock price fluctuates from time to time and may fall below expectations of securities analysts and investors, and could subject us to litigation, which may result in you suffering a loss on your investment.*

The market price of our common stock may fluctuate significantly in response to a number of factors, some of which are beyond our control. These factors include: quarterly variations in operating results; changes in accounting treatments or principles; announcements by us or our competitors of new products and services offerings, significant contracts, acquisitions or strategic relationships; additions or departures of key personnel; any future sales of our common stock or other securities; stock market price and volume fluctuations of publicly-traded companies; and general political, economic and market conditions.

In some future quarter our operating results may fall below the expectations of securities analysts and investors, which could result in a decrease in the trading price of our common stock. In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We may be the targets of similar litigation in the future. Securities litigation could result in substantial costs and divert management's attention and resources, which could seriously harm our business and operating results.

*The interest of our controlling stockholder could conflict with those of our other stockholders.*

Tricon Holdings, LLC, ("Tricon") our largest stockholder, owns and controls 12.1% of our voting securities. This stockholder is able to influence the outcome of stockholder votes, including votes concerning: the election of directors; amendments to our charter and by-laws; and the approval of significant corporate transactions such as a merger or sale of our assets. This controlling influence could have the effect of delaying or preventing a change in control, even if many of our stockholders believe it is in their best interest.

*We may issue additional shares of preferred stock that could defer a change of control or dilute the interests of our common stockholders. Our charter documents could defer a takeover effort which could inhibit your ability to receive an acquisition premium for your shares.*

Our charter permits our Board of Directors to issue up to 5,000,000 shares of preferred stock without stockholder approval. Currently there are 2,500 shares of our Convertible Preferred Stock issued and outstanding. This leaves 4,997,500 shares of preferred stock available for issuance at the discretion of our Board of Directors. These shares, if issued, could contain dividend, liquidation, conversion, voting or other rights which could adversely affect the rights of our common stockholders and which could also be utilized, under some circumstances, as a method of discouraging, delaying or preventing a change in control. Provisions of our articles of incorporation, bylaws and Florida law could make it more difficult for a third party to acquire us, even if many of our stockholders believe it is in their best interest.

## **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None

## **ITEM 2. PROPERTIES**

Our facilities, including our principal executive offices, are located at 1441 S.W. 29<sup>th</sup> Avenue, Pompano Beach, Florida 33069. The Company leases its executive offices and warehouse facility under a non-cancelable operating lease. The Company is responsible for certain maintenance costs, taxes and insurance under this lease. On May 18, 2005 the Company signed an amendment to extend the current lease agreement through May 31, 2009. The amendment terms are similar to the existing lease agreement, and the Company exercised its option to lease an additional 3,600 square feet. On November 28, 2005 the Company signed a fourth amendment to its current lease agreement. The Company agreed to lease an additional 7,000 square feet to expand its warehouse and pharmacy. This addition to the warehouse and pharmacy was necessary to increase the Company's capacity to store additional inventory and expand its fulfillment operations. Under the terms of the new amendments the Company will be leasing a total 50,000 square feet through May 31, 2009. The future minimum annual lease payments are as follows: \$481,000 for fiscal 2007, \$500,000 for fiscal 2008, \$520,000 for fiscal 2009, and \$87,000 for fiscal 2010.

### **ITEM 3. LEGAL PROCEEDINGS**

The Company is a defendant in a lawsuit, filed in August 2002, in Texas state district court seeking injunctive and monetary relief styled Texas State Board of Pharmacy and State Board of Veterinary Medical Examiners v. PetMed Express, Inc. Cause No. GN-202514, in the 201st Judicial District Court, Travis County, Texas. The Company in its initial pleading denied the allegations contained therein. The Company is vigorously defending, is confident of its compliance with the applicable law, and finds wrong-on-the-facts the vast majority of the allegations contained in the Plaintiffs' supporting documentation attached to the lawsuit. We are currently negotiating a settlement of the matter, although there can be no assurances that the negotiations will be successful. Thus, at this stage it is difficult to assess the outcome or estimate any potential loss in the event of an adverse outcome.

On January 19, 2006, PetMed Express, Inc. was added as a defendant in the matter of Yali Golan v. Marc Puleo (former President and current Chairman of the Board of Directors of the Company), filed in the Circuit Court of the Eleventh Judicial Circuit in and for Miami-Dade County, Florida which had originally been filed solely against Dr. Puleo in March 2003. This action is based upon allegations by the plaintiff that Dr. Puleo individually entered into a written agreement with the plaintiff (the purported "General Agreement," of which the plaintiff has not produced an original document) which in pertinent part granted plaintiff 50% of any salary, stock or stock options received by Dr. Puleo from the Company for so long as the Company remains in business. The plaintiff now alleges that the Company's past and continuing failure to disclose the purported General Agreement in filings with the SEC has caused the plaintiff to suffer damages. The plaintiff is seeking a judgment against the Company for specific performance and unspecified damages, pre- and post-judgment interest, court fees and such other relief as the court deems appropriate. The Company believes that, based on information currently available to it, the claims being asserted against it are factually and legally without merit, and the Company intends to vigorously defend against such claims.

#### **Routine Proceedings**

The Company is a party to routine litigation and administrative complaints incidental to its business. Management does not believe that the resolution of any or all of such routine litigation and administrative complaints is likely to have a material adverse effect on the Company's financial condition or results of operations. The Company has settled complaints that had been filed with various states' pharmacy boards in the past. There can be no assurances made that other states will not attempt to take similar actions against the Company in the future. Legal costs related to the above matters are expensed as incurred.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matter was submitted to a vote of our stockholders during the fourth quarter of the fiscal year ended March 31, 2006.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's common shares are traded on the Nasdaq National Market ("NASDAQ") under the symbol "PETS." The prices set forth below reflect the range of high and low closing prices per share in each of the quarters of fiscal 2006 and 2005 as reported by the NASDAQ:

| <b>Fiscal 2006:</b> | <b>High</b> | <b>Low</b> |
|---------------------|-------------|------------|
| First Quarter       | \$8.21      | \$6.50     |
| Second Quarter      | \$11.64     | \$7.63     |
| Third Quarter       | \$15.52     | \$9.83     |
| Fourth Quarter      | \$19.99     | \$14.34    |

| <b>Fiscal 2005:</b> | <b>High</b> | <b>Low</b> |
|---------------------|-------------|------------|
| First Quarter       | \$12.29     | \$6.73     |
| Second Quarter      | \$8.10      | \$4.10     |
| Third Quarter       | \$7.61      | \$4.63     |
| Fourth Quarter      | \$8.55      | \$6.50     |

There were 61 holders of record of our common stock at May 31, 2006, and we estimate there were approximately 14,400 beneficial stockholders on that date.

#### *Dividend Policy*

The Company has never paid cash dividends on our common stock. We presently intend to retain future earnings to finance the expansion of our business. Our future dividend policy will depend on our earnings, capital requirements, expansion plans, financial condition and other relevant factors.

## ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data should be read together with "Management's Discussion and Analysis of Financial Condition and Results of Operations," the consolidated financial statements and notes thereto and other financial information included elsewhere in this Annual Report. The consolidated statements of income data set forth below for the fiscal years ended March 31, 2006, 2005, and 2004 and the consolidated balance sheet data as of March 31, 2006 and 2005 have been derived from our audited consolidated financial statements which are included elsewhere in this Form 10-K. The consolidated statements of income data set forth below for the fiscal years ended March 31, 2003 and 2002 and the consolidated balance sheet data as of March 31, 2004, 2003 and 2002 have been derived from our audited consolidated financial statements which are not included in this Form 10-K.

### STATEMENTS OF INCOME

|   | Fiscal Year Ended March 31, |                |               |               |               |
|---|-----------------------------|----------------|---------------|---------------|---------------|
|   | 2006                        | 2005           | 2004          | 2003          | 2002          |
| Sales   | \$ 137,583,155              | \$ 108,357,747 | \$ 93,994,233 | \$ 54,974,916 | \$ 32,025,931 |
| Cost of sales   | 83,244,366                  | 64,700,002     | 55,824,406    | 31,517,639    | 18,894,493    |
| Gross profit  | 54,338,789                  | 43,657,745     | 38,169,827    | 23,457,277    | 13,131,438    |
| Operating expenses                                    | 36,193,545                  | 31,156,119     | 28,958,433    | 19,974,270    | 12,383,498    |
| Net income  | 12,063,514                  | 8,010,370      | 5,813,604     | 3,257,565     | 825,413       |
| Net income per common share:                          |                             |                |               |               |               |
| Basic   | 0.51                        | 0.35           | 0.30          | 0.19          | 0.05          |
| Diluted   | 0.50                        | 0.34           | 0.25          | 0.16          | 0.04          |
| Weighted average number of common shares outstanding: |                             |                |               |               |               |
| Basic   | 23,658,722                  | 22,862,417     | 19,471,681    | 17,300,130    | 16,360,010    |
| Diluted   | 24,211,955                  | 23,833,189     | 23,689,866    | 20,749,515    | 19,739,493    |

### BALANCE SHEET DATA

|                      | March 31,     |               |               |              |            |
|----------------------|---------------|---------------|---------------|--------------|------------|
|                      | 2006          | 2005          | 2004          | 2003         | 2002       |
| Working capital      | \$ 34,968,771 | \$ 21,968,784 | \$ 11,338,004 | \$ 3,017,641 | \$ 690,588 |
| Total assets         | 42,624,159    | 28,119,483    | 18,480,808    | 9,025,796    | 4,654,236  |
| Total liabilities    | 4,984,630     | 3,902,419     | 4,486,299     | 3,433,108    | 3,071,536  |
| Shareholders' equity | 37,639,529    | 24,217,064    | 13,994,509    | 5,592,688    | 1,582,700  |

### NON FINANCIAL DATA (UNAUDITED)

|                                 | March 31, |           |           |         |         |
|---------------------------------|-----------|-----------|-----------|---------|---------|
|                                 | 2006      | 2005      | 2004      | 2003    | 2002    |
| New customers acquired          | 624,000   | 510,000   | 572,000   | 414,000 | 275,000 |
| Total accumulated customers (1) | 2,455,000 | 1,831,000 | 1,321,000 | 749,000 | 335,000 |

(1) includes both active and inactive customers

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Executive Summary**

PetMed Express was incorporated in the state of Florida in January 1996. The Company's common stock is traded on the NASDAQ under the symbol "PETS." Prior to the move to the NASDAQ, the Company's shares had been traded on the over-the-counter bulletin board. The Company began selling pet medications and other pet health products in September 1996, and issued its first catalog in the fall of 1997. This catalog displayed approximately 1,200 items, including prescription and non-prescription pet medications, other pet health products and pet accessories. In fiscal 2001, the Company focused its product line on approximately 600 of the most popular pet medications and other health products for dogs and cats. Presently, the Company's product line includes approximately 750 of the most popular pet medications and other health products for dogs, cats, and horses.

The Company markets its products through national television, online, and direct mail/print advertising campaigns which direct consumers to order by phone or on the Internet, and aim to increase the recognition of the "1-800-PetMeds" brand name. Currently, approximately 57% of all sales are generated via the Internet compared to 53% last year.

The Company's sales consist of products sold mainly to retail consumers and minimally to wholesale customers. Typically, the Company's customers pay by credit card or check at the time the order is shipped. The Company usually receives cash settlement in two to three banking days for sales paid by credit cards, which minimizes the accounts receivable balances relative to the Company's sales. Certain wholesale customers are extended credit terms, which usually require payment within 30 days of delivery. The Company's sales returns average was approximately 1.5 % and 1.4 % of sales for the fiscal years ended March 31, 2006 and 2005, respectively. The twelve month average purchase was approximately \$77 and \$76 per order for the fiscal years ended March 31, 2006 and 2005, respectively.

### **Critical Accounting Policies**

Our discussion and analysis of our financial condition and the results of our operations are based upon our condensed consolidated financial statements and the data used to prepare them. The Company's condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. On an ongoing basis we re-evaluate our judgments and estimates including those related to product returns, bad debts, inventories, long-lived assets, income taxes, litigation and contingencies. We base our estimates and judgments on our historical experience, knowledge of current conditions and our beliefs of what could occur in the future considering available information. Actual results may differ from these estimates under different assumptions or conditions. Our estimates are guided by observing the following critical accounting policies.

#### **Revenue recognition**

The Company generates revenue by selling pet medication products primarily to retail consumers and minimally to wholesale customers. The Company's policy is to recognize revenue from product sales upon shipment, when the rights of ownership and risk of loss have passed to the consumer. Outbound shipping and handling fees are included in sales and are billed upon shipment. Shipping expenses are included in cost of sales.

The majority of the Company's sales are paid by credit cards and the Company usually receives the cash settlement in two to three banking days. Credit card sales minimize accounts receivable balances relative to sales. The Company maintains an allowance for doubtful accounts for losses that the Company estimates will arise from the customers' inability to make required payments, arising from either credit card charge-backs or insufficient funds checks. The Company determines its estimates of the uncollectibility of accounts receivable by analyzing historical bad debts and current economic trends. At March 31, 2006 and 2005 the allowance for doubtful accounts was approximately \$23,000 and \$37,000, respectively.

#### **Valuation of inventory**

Inventories consist of prescription and non-prescription pet medications and pet supplies that are available for sale and are priced at the lower of cost or market value using a weighted average cost method. The Company writes down its inventory for estimated obsolescence. The inventory reserve was approximately \$306,000 and \$228,000 for the fiscal years ended March 31, 2006 and 2005, respectively.

## Property and equipment

Property and equipment are stated at cost and depreciated using the straight-line method over the estimated useful lives of the assets. The furniture, fixtures, equipment and computer software are depreciated over periods ranging from three to seven years. Leasehold improvements and assets under capital lease agreements are amortized over the shorter of the underlying lease agreement or the useful life of the asset.

## Long-lived assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Recoverability of assets is measured by a comparison of the carrying amount of the asset to net future cash flows expected to be generated from the asset.

## Advertising

The Company's advertising expense consists primarily of television advertising, internet marketing, and direct mail/print advertising. Television costs are expensed as the advertisements are televised. Internet costs are expensed in the month incurred and direct mail/print advertising costs are expensed when the related catalog and postcards are produced, distributed or superseded.

## Accounting for income taxes

The Company accounts for income taxes under the provisions of SFAS No. 109, *Accounting for Income Taxes*, which generally requires recognition of deferred tax assets and liabilities for the expected future tax benefits or consequences of events that have been included in the condensed consolidated financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting carrying values and the tax bases of assets and liabilities, and are measured by applying enacted tax rates and laws for the taxable years in which those differences are expected to reverse.

## Results of Operations

The following should be read in conjunction with the Company's Consolidated Financial Statements and the related notes thereto included elsewhere herein. The following table sets forth, as a percentage of sales, certain items appearing in the Company's Consolidated Statements of Income:

|  | Fiscal Year Ended March 31, |              |              |
|--|-----------------------------|--------------|--------------|
|  | 2006                        | 2005         | 2004         |
| Sales                                    | 100.0 %                     | 100.0 %      | 100.0 %      |
| Cost of sales                            | 60.5                        | 59.7         | 59.4         |
| Gross profit                             | <u>39.5</u>                 | <u>40.3</u>  | <u>40.6</u>  |
| Operating expenses:                      |                             |              |              |
| General and administrative               | 10.2                        | 10.6         | 11.4         |
| Advertising                              | 15.7                        | 17.7         | 18.8         |
| Depreciation and amortization            | 0.4                         | 0.5          | 0.6          |
| Total operating expenses                 | <u>26.3</u>                 | <u>28.8</u>  | <u>30.8</u>  |
| Income from operations                   | <u>13.2</u>                 | <u>11.5</u>  | <u>9.8</u>   |
| Total other income (expense)             | <u>0.7</u>                  | <u>0.1</u>   | <u>-</u>     |
| Income before provision for income taxes | 13.9                        | 11.6         | 9.8          |
| Provision for income taxes               | 5.1                         | 4.2          | 3.6          |
| Net income                               | <u>8.8 %</u>                | <u>7.4 %</u> | <u>6.2 %</u> |

## **Fiscal 2006 Compared to Fiscal 2005**

### **Sales**

Sales increased \$29,225,000, or 27.0%, to \$137,583,000 for the year ended March 31, 2006, from \$108,358,000 for the year ended March 31, 2005. The increase in sales can be primarily attributed to increased retail new orders, retail reorders and wholesale sales, during the fiscal year.

The Company has committed certain amounts specifically designated towards television, direct mail/print and online advertising to stimulate sales, create brand awareness, and acquire new customers. Retail reorder sales have increased by approximately \$19,648,000, or 28.6%, to approximately \$88,367,000 for the fiscal year ended March 31, 2006, from approximately \$68,719,000 for the fiscal year ended March 31, 2005. Retail new order sales have increased by approximately \$8,280,000, or 22.3%, to approximately \$45,488,000 for the fiscal year ended March 31, 2006, from approximately \$37,208,000 for the fiscal year ended March 31, 2005. Wholesale sales have increased by approximately \$1,297,000, or 53.4%, to approximately \$3,728,000 for the fiscal year ended March 31, 2006, from approximately \$2,431,000 for the fiscal year ended March 31, 2005. We may limit our wholesale sales in the future to focus our business on retail sales. The Company acquired approximately 624,000 new customers for the year ended March 31, 2006, compared to 510,000 new customers for the same period in the prior year. The increase in retail sales growth for fiscal 2006 compared to fiscal 2005 can be attributed to increased advertising effectiveness, due to a more favorable advertising environment, with more effective creative, and discount offers. There can be no assurances that this trend will continue due to increased price competition from veterinarians and traditional and online retailers.

The majority of our product sales are affected by the seasons, due to the seasonality of mainly heartworm and flea and tick medications. For the quarters ended June 30, September 30, December 31, and March 31 of fiscal 2006, the Company's sales were approximately 32%, 28%, 19%, and 21%, respectively.

### **Cost of sales**

Cost of sales increased by \$18,544,000, or 28.7%, to \$83,244,000 for the fiscal year ended March 31, 2006, from \$64,700,000 for the fiscal year ended March 31, 2005. The increase in cost of sales is directly related to the increase in retail and wholesale sales in fiscal 2006 as compared to fiscal 2005. As a percent of sales, the cost of sales was 60.5% in fiscal 2006, as compared to 59.7% in fiscal 2005. The percentage increase can be attributed to increases in our product and freight costs, discounts given to our customers, and increases in our wholesale sales, which have a lower gross profit percentage.

### **Gross profit**

Gross profit increased by \$10,681,000, or 24.5%, to \$54,339,000 for the fiscal year ended March 31, 2006, from \$43,658,000 for the fiscal year ended March 31, 2005. Gross profit as a percentage of sales for fiscal 2006 and 2005 was 39.5% and 40.3%, respectively. The gross profit percentage decrease can be attributed to increases in our product and freight costs, discounts given to our customers, and increases in our wholesale sales, which have a lower gross profit percentage.

### **General and administrative expenses**

General and administrative expenses increased by \$2,682,000, or 23.5%, to \$14,078,000 for the fiscal year ended March 31, 2006 from \$11,396,000 for the fiscal year ended March 31, 2005. However, general and administrative expense as a percentage of sales was 10.2% compared to 10.6% for the fiscal years ended March 31, 2006 and 2005, respectively. The increase in general and administrative expenses for the year ended March 31, 2006 was primarily due to the following: a \$798,000 increase to payroll expenses which can be attributed to the addition of new employees in the customer care and pharmacy departments enabling the company to sustain its growth; a \$663,000 increase to professional fees, primarily relating to increased pharmacist, accounting, the majority relating to Sarbanes Oxley compliance, and legal fees; a \$646,000 increase to credit card and bank service fees which is directly attributable to increased sales in the period; a \$183,000 increase to property expenses, relating to unanticipated hurricane-related charges, mainly generator and fuel expenses, during the third quarter and additional rent due to our warehouse expansion; a \$162,000 one-time charge relating to state/county sales tax which was not collected on behalf of our customers; a \$110,000 increase to telephone expenses resulting from receiving one time usage credits in the quarters ended September 30, 2004 and December 31, 2004; a \$85,000 increase to office expenses which can be directly attributed to increased sales and unanticipated hurricane-related charges in the period; a \$36,000 increase to insurance expenses, relating to an increase in premiums paid; and a \$1,000 decrease to other expenses.

## **Advertising expenses**

Advertising expenses increased by approximately \$2,385,000, or approximately 12.4%, to approximately \$21,571,000 for the fiscal year ended March 31, 2006 from approximately \$19,186,000 for the fiscal year ended March 31, 2005. The increase in advertising expenses for the fiscal year ended March 31, 2006 was due to the Company's plan to commit certain amounts specifically designated towards television, direct mail/print, and online advertising to stimulate sales, create brand awareness, and acquire new customers.

The advertising costs of acquiring a new customer, defined as total advertising costs divided by new customers acquired, for the fiscal year ended March 31, 2006 was \$35, compared to \$38 for the same period the prior year. We can attribute this reduction to an increase in advertising efficiency due to a more favorable advertising environment. There can be no assurances made that this favorable advertising environment will continue. Historically, the advertising environment fluctuates due to supply and demand. A less favorable advertising environment may negatively impact new order sales. As a percentage of sales, advertising expense was 15.7% in fiscal 2006, as compared to 17.7% in fiscal 2005. The Company currently anticipates advertising as a percentage of sales to range from approximately 15.0% to 16.0% in fiscal 2007. However, the advertising percentage will fluctuate quarter to quarter due to seasonality and advertising availability. For the year ended March 31, 2006, quarterly advertising expenses as a percentage of sales ranged between 12% and 18%.

## **Depreciation and amortization**

Depreciation and amortization decreased by approximately \$29,000, or 5.1%, to approximately \$545,000 for the fiscal year ended March 31, 2006 from approximately \$574,000 for the fiscal year ended March 31, 2005. This decrease to depreciation and amortization expense for fiscal 2006 can be attributed to decreased property and equipment additions since the first quarter of fiscal 2005.

## **Other income**

Other income increased by approximately \$788,000 to approximately \$890,000 for the fiscal year ended March 31, 2006, from approximately \$102,000 for the fiscal year ended March 31, 2005. The increase to other income can be primarily attributed to increased interest income due to increases in the Company's cash balance, which is swept into an interest bearing overnight account and tax-free short term investment account, and to advertising revenue generated from our website. Interest income may decrease in future years as the Company utilizes its cash balances on operating activities.

## **Provision for income taxes**

For the fiscal years ended March 31, 2006 and 2005, the Company recorded an income tax provision for approximately \$6,972,000 and \$4,593,000, respectively, which resulted in an effective tax rate of 36.6% and 36.4%, respectively.

## **Net income**

Net income increased by approximately \$4,054,000, or 50.6%, to approximately \$12,064,000 for the fiscal year ended March 31, 2006 from approximately \$8,010,000 for the fiscal year ended March 31, 2005. The significant increase was mainly attributable to the Company's sales growth and profitable operations and the leverage of general and administrative and advertising expenses.

## **Fiscal 2005 Compared to Fiscal 2004**

### **Sales**

Sales increased \$14,364,000, or 15.3%, to \$108,358,000 for the year ended March 31, 2005, from \$93,994,000 for the year ended March 31, 2004. The increase in sales can be primarily attributed to increased retail reorders and wholesale sales, partially offset by decreased retail new order sales during the fiscal year.

The Company has committed certain amounts specifically designated towards television, direct mail/print and online advertising to stimulate sales, create brand awareness, and acquire new customers. Retail reorder sales have increased by approximately \$17,285,000, or 33.6%, to approximately \$68,719,000 for the fiscal year ended March 31, 2005, from approximately \$51,434,000 for the fiscal year ended March 31, 2004. Retail new order sales have decreased by approximately \$4,908,000, or 11.7%, to approximately \$37,208,000 for the fiscal year ended March 31, 2005, from approximately \$42,116,000 for the fiscal year ended March 31, 2004. Wholesale sales have increased by approximately \$1,987,000, or 447%, to approximately \$2,431,000 for the fiscal year ended March 31, 2005, from approximately \$444,000 for the fiscal year ended March 31, 2004. The Company acquired approximately 510,000 new customers for the year ended

March 31, 2005, compared to 572,000 new customers for the same period in the prior year. The slow down in retail sales growth for fiscal 2005 compared to fiscal 2004 can be attributed to decreased advertising efficiency and increased competition both from veterinarians and traditional and online retailers.

The majority of our product sales are affected by the seasons, due to the seasonality of mainly heartworm and flea and tick medications. For the quarters ended June 30, September 30, December 31, and March 31 of fiscal 2005, the Company's sales were approximately 33%, 26%, 19%, and 22%, respectively.

### **Cost of sales**

Cost of sales increased by \$8,876,000, or 15.9%, to \$64,700,000 for the fiscal year ended March 31, 2005, from \$55,824,000 for the fiscal year ended March 31, 2004. The increase in cost of sales is directly related to the increase in retail and wholesale sales in fiscal 2005 as compared to fiscal 2004. As a percent of sales, the cost of sales was 59.7% in fiscal 2005, as compared to 59.4% in fiscal 2004. The percentage increase can be attributed to increases in wholesale sales which had a higher cost of sales percentage.

### **Gross profit**

Gross profit increased by \$5,488,000, or 14.4%, to \$43,658,000 for the fiscal year ended March 31, 2005, from \$38,170,000 for the fiscal year ended March 31, 2004. Gross profit as a percentage of sales for fiscal 2005 and 2004 was 40.3% and 40.6%, respectively. The percentage decrease can be attributed to increases in wholesale sales which had a lower gross profit percentage.

### **General and administrative expenses**

General and administrative expenses increased by \$642,000, or 6.0%, to \$11,396,000 for the fiscal year ended March 31, 2005 from \$10,754,000 for the fiscal year ended March 31, 2004. However, general and administrative expense as a percentage of sales was 10.6% and 11.4% for the fiscal years ended March 31, 2005 and 2004, respectively. The increase in general and administrative expenses for the year ended March 31, 2005 was primarily due to the following: a \$336,000 increase in bank service and credit card fees which can be directly attributed to increased sales in fiscal 2005; a \$259,000 increase to payroll expenses due to the addition of new employees in the customer care and pharmacy departments enabling the company to sustain its growth; a \$106,000 increase to property expenses relating to additional rent due to our warehouse expansion; a \$97,000 increase in insurance expenses, relating to additional premiums paid for increases to insurance policy limits; and a \$70,000 increase in other expenses which includes mainly office expenses. Offsetting the increase were an \$113,000 reduction to telephone expenses, relating to one time usage credits received in fiscal 2005, and an \$113,000 reduction to professional fees primarily from a one-time NASDAQ listing fee in fiscal 2004.

### **Advertising expenses**

Advertising expenses increased by approximately \$1,532,000, or approximately 8.7%, to approximately \$19,186,000 for the fiscal year ended March 31, 2005 from approximately \$17,654,000 for the fiscal year ended March 31, 2004. The increase in advertising expenses for the fiscal year ended March 31, 2005 was due to the Company's plan to commit certain amounts specifically designated towards television, direct mail/print, and online advertising to stimulate sales, create brand awareness, and acquire new customers.

The advertising costs of acquiring a new customer, defined as total advertising costs divided by new customers acquired, for the fiscal year ended March 31, 2005 was \$38, compared to \$31 for the same period the prior year. We can attribute this decrease in advertising efficiency for the year ended March 31, 2005 compared to 2004 to the change in the advertising media mix caused by a shortage of television advertising inventory, which was due to increased advertiser demand resulting from the strengthening economy and the presidential election. The decrease in advertising efficiency may also be attributable to increased competition from both veterinarians and traditional and online retailers. As a percentage of sales, advertising expense was 17.7% in fiscal 2005, as compared to 18.8% in fiscal 2004. The percentage decrease can also be attributed to the shortage of television advertising inventory mentioned above. The Company expects advertising as a percentage of sales to range from approximately 17.0% to 20.0% in fiscal 2006. However, the advertising percentage will fluctuate quarter to quarter due to seasonality and advertising availability.

### **Depreciation and amortization**

Depreciation and amortization increased by approximately \$24,000, or 4.3%, to approximately \$574,000 for the fiscal year ended March 31, 2005 from approximately \$550,000 for the fiscal year ended March 31, 2004. The increase to depreciation and amortization expense for fiscal 2005 can be attributed to property and equipment additions.

### **Interest income**

Interest income increased by approximately \$89,000, or 917%, to approximately \$99,000 for the fiscal year ended March 31, 2005 from approximately \$10,000 for the fiscal year ended March 31, 2004. The increase to interest income can be attributed to increases in the Company's cash balance, which is swept into an interest bearing overnight account and tax-free short term investment accounts. Interest income may decrease in future years as the Company utilizes its cash balances to increase inventory levels.

### **Provision for income taxes**

For the fiscal years ended March 31, 2005 and 2004, the Company recorded an income tax provision for approximately \$4,593,000 and \$3,400,000, respectively, which resulted in an effective tax rate of 36.4% and 36.9%, respectively.

### **Net income**

Net income increased by approximately \$2,196,000, or 37.8%, to approximately \$8,010,000 for the fiscal year ended March 31, 2005 from approximately \$5,814,000 for the fiscal year ended March 31, 2004. The significant increase was mainly attributable to the Company's sales growth and profitable operations and the leverage of general and administrative and advertising expenses.

### **Liquidity and Capital Resources**

The Company's working capital at March 31, 2006 and 2005 was \$34,969,000 and \$21,969,000, respectively. The \$13,000,000 increase in working capital was primarily attributable to cash flow generated from operations and the exercise of stock options. Net cash provided by operating activities was \$10,277,000 and \$8,349,000 for the years ended March 31, 2006 and 2005, respectively. Net cash used in investing activities was \$758,000 and \$172,000 for the years ended March 31, 2006 and 2005, respectively. This \$586,000 increase to property and equipment acquisitions can be directly attributed to the Company's expansion in the warehouse, pharmacy and fulfillment operations, to add additional computer equipment to further the Company's growth and add back-up infrastructure, and to maintain existing capital assets in fiscal 2006. Net cash provided by financing activities was \$1,016,000 and \$1,225,000 for the years ended March 31, 2006 and 2005. This \$209,000 decrease can be attributed to a decrease in the number of stock options being exercised in fiscal 2006 compared to fiscal 2005.

As of March 31, 2006 and 2005 the Company had no outstanding lease commitments except for the lease for its executive offices and warehouse ("facility"). On May 18, 2005 the Company signed an amendment to extend the current lease agreement through May 31, 2009. The amendment terms are similar to the existing lease agreement, and the Company exercised its option to lease an additional 3,600 square feet. On November 28, 2005 the Company signed an amendment to its current lease agreement. The Company agreed to lease an additional 7,000 square feet to expand its warehouse and pharmacy. This addition to the warehouse and pharmacy was necessary to increase the Company's capacity to store additional inventory and expand its fulfillment operations.

Since its inception, the Company has primarily funded its growth through the private placement of securities. The Company had financed certain equipment acquisitions with capital leases.

The Company's \$5,000,000 line of credit with SouthTrust Bank, N.A. expired on August 28, 2004. On November 2, 2004 the Company signed a new \$6,000,000 line of credit agreement with RBC Centura Bank ("RBC"). The \$6,000,000 line of credit, which upon 30 days notice had a provision to increase the line to \$7,500,000, was effective through November 2, 2005. On October 31, 2005, the Company and RBC agreed to extend the maturity date of the existing line of credit for a period of 90 days. On February 3, 2006, the Company and RBC agreed to extend the maturity date of the existing line of credit for an additional 45 days. The Company determined that it no longer had a need for this line of credit and it was not renewed. At March 31, 2006 and 2005, there was no balance outstanding under either line of credit agreement.

Presently, the Company has approximately \$500,000 planned for capital expenditure commitments to further the Company's growth during fiscal 2007, which will be funded through cash from operations. The Company's source of working capital includes cash from operations and the exercise of stock options. The Company presently has no need for other alternative sources of working capital and at this time, have no commitments or plans to obtain additional capital. If in the future, the Company seeks to raise additional capital through the sale of equity securities, no assurances can be given that the Company will be successful in obtaining additional capital, or that such capital will be available in terms acceptable to the Company. Further, there can be no assurances that even if such additional capital is obtained that the Company will sustain profitability or positive cash flow.

## **Recent Accounting Pronouncements**

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R, *Share Based Payment*, which is a revision of SFAS No. 123. This Statement supersedes APB No. 25, which is the basis for the Company's current policy on accounting for stock-based compensation. SFAS No. 123R will require companies to recognize as an expense in the Statement of Income the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS No. 123R is effective for the Company as of April 1, 2006, the beginning of the quarter ending June 30, 2006. Under the methods of adoption allowed by the standard, awards that are granted, modified, or settled after the date of adoption should be measured and accounted for in accordance with SFAS No. 123R. The fair value of unvested equity-classified awards that were granted prior to the effective date should be measured in accordance with SFAS No. 123 and recognized as compensation expense in the Statement of Income.

The Company does not believe that any other recently issued, but not yet effective, accounting standard, if currently adopted, will have a material effect on the Company's consolidated financial position, results of operations or cash flows.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk generally represents the risk that losses may occur in the value of financial instruments as a result of movements in interest rates, foreign currency exchange rates and commodity prices. Our financial instruments include cash and cash equivalents, accounts receivable, accounts payable, line of credit, and debt obligations. The book values of cash equivalents, accounts receivable, and accounts payable are considered to be representative of fair value because of the short maturity of these instruments. At March 31, 2006, we had no debt obligations.

We do not utilize financial instruments for trading purposes and we do not hold any derivative financial instruments that could expose us to significant market risk. Our exposure to market risk for changes in interest rates related primarily to our obligations under our line of credit, which was not renewed in fiscal 2006.

The above sensitivity analysis for interest rate risk excludes accounts receivable, accounts payable and accrued liabilities because of the short-term maturity of such instruments. The analysis does not consider the effect this movement may have on other variables including changes in revenue volumes that could be indirectly attributed to changes in interest rates. The actions that management would take in response to such a change are also not considered. If it were possible to quantify this impact, the results could well be different than the sensitivity effects shown above.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**PETMED EXPRESS, INC. AND SUBSIDIARIES**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders  
PetMed Express, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of PetMed Express, Inc. and Subsidiaries (the “Company”) as of March 31, 2006 and 2005, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended March 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of PetMed Express, Inc. and Subsidiaries as of March 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2006, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of March 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated May 11, 2006 expressed an unqualified opinion thereon.

/s/ Goldstein Golub Kessler LLP  
Goldstein Golub Kessler LLP

New York, New York  
May 11, 2006

**PETMED EXPRESS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

March 31,

2006

2005

**ASSETS**

Current assets:

|  |    |            |    |            |
|--|----|------------|----|------------|
| Cash and cash equivalents  | \$ | 23,216,907 | \$ | 12,680,962 |
| Accounts receivable, less allowance for doubtful accounts of \$23,000 and \$37,000, respectively |    | 1,155,781  |    | 1,796,756  |
| Inventories - finished goods   |    | 14,997,675 |    | 11,180,333 |
| Prepaid expenses and other current assets  |    | 583,038    |    | 213,152    |
| Total current assets   |    | 39,953,401 |    | 25,871,203 |

|                             |  |           |  |           |
|-----------------------------|--|-----------|--|-----------|
| Property and equipment, net |  | 1,497,589 |  | 1,286,267 |
| Deferred income taxes       |  | 794,002   |  | 582,846   |
| Intangible asset            |  | 365,000   |  | 365,000   |
| Other assets                |  | 14,167    |  | 14,167    |

|              |    |            |    |            |
|--------------|----|------------|----|------------|
| Total assets | \$ | 42,624,159 | \$ | 28,119,483 |
|--------------|----|------------|----|------------|

**LIABILITIES AND SHAREHOLDERS' EQUITY**

Current liabilities:

|  |    |           |    |           |
|--|----|-----------|----|-----------|
| Accounts payable                               | \$ | 3,052,953 | \$ | 2,724,990 |
| Income taxes payable                           |    | 958,318   |    | 601,535   |
| Accrued expenses and other current liabilities |    | 973,359   |    | 575,894   |

|                   |  |           |  |           |
|-------------------|--|-----------|--|-----------|
| Total liabilities |  | 4,984,630 |  | 3,902,419 |
|-------------------|--|-----------|--|-----------|

Commitments and contingencies

Shareholders' equity:

|   |  |            |  |            |
|---|--|------------|--|------------|
| Preferred stock, \$.001 par value, 5,000,000 shares authorized;<br>2,500 convertible shares issued and outstanding with a liquidation preference of \$4 per share |  | 8,898      |  | 8,898      |
| Common stock, \$.001 par value, 40,000,000 shares authorized;<br>23,967,390 and 23,458,725 shares issued and outstanding, respectively                            |  | 23,967     |  | 23,459     |
| Additional paid-in capital  |  | 13,433,054 |  | 12,074,611 |
| Retained earnings   |  | 24,173,610 |  | 12,110,096 |
| Total shareholders' equity  |  | 37,639,529 |  | 24,217,064 |

|  |    |            |    |            |
|--|----|------------|----|------------|
| Total liabilities and shareholders' equity | \$ | 42,624,159 | \$ | 28,119,483 |
|--|----|------------|----|------------|

See accompanying notes to consolidated financial statements

**PETMED EXPRESS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

|   | <b>Year Ended March 31,</b> |                     |                     |
|---|-----------------------------|---------------------|---------------------|
|   | <u><b>2006</b></u>          | <u><b>2005</b></u>  | <u><b>2004</b></u>  |
| Sales   | \$ 137,583,155              | \$ 108,357,747      | \$ 93,994,233       |
| Cost of sales   | <u>83,244,366</u>           | <u>64,700,002</u>   | <u>55,824,406</u>   |
| Gross profit  | <u>54,338,789</u>           | <u>43,657,745</u>   | <u>38,169,827</u>   |
| Operating expenses:                                   |                             |                     |                     |
| General and administrative                            | 14,078,343                  | 11,396,320          | 10,754,427          |
| Advertising   | 21,570,667                  | 19,185,982          | 17,653,614          |
| Depreciation and amortization                         | <u>544,535</u>              | <u>573,817</u>      | <u>550,392</u>      |
| Total operating expenses                              | <u>36,193,545</u>           | <u>31,156,119</u>   | <u>28,958,433</u>   |
| Income from operations                                | <u>18,145,244</u>           | <u>12,501,626</u>   | <u>9,211,394</u>    |
| Other income (expense):                               |                             |                     |                     |
| Loss on disposal of property and equipment            | (1,719)                     | -                   | -                   |
| Interest expense                                      | -                           | (965)               | (14,546)            |
| Interest income                                       | 676,083                     | 99,044              | 9,739               |
| Other, net  | <u>215,586</u>              | <u>3,710</u>        | <u>6,938</u>        |
| Total other income (expense)                          | <u>889,950</u>              | <u>101,789</u>      | <u>2,131</u>        |
| Income before provision for income taxes              | 19,035,194                  | 12,603,415          | 9,213,525           |
| Provision for income taxes                            | <u>6,971,680</u>            | <u>4,593,045</u>    | <u>3,399,921</u>    |
| Net income  | <u>\$ 12,063,514</u>        | <u>\$ 8,010,370</u> | <u>\$ 5,813,604</u> |
| Net income per common share:                          |                             |                     |                     |
| Basic   | <u>\$ 0.51</u>              | <u>\$ 0.35</u>      | <u>\$ 0.30</u>      |
| Diluted   | <u>\$ 0.50</u>              | <u>\$ 0.34</u>      | <u>\$ 0.25</u>      |
| Weighted average number of common shares outstanding: |                             |                     |                     |
| Basic   | <u>23,658,722</u>           | <u>22,862,417</u>   | <u>19,471,681</u>   |
| Diluted   | <u>24,211,955</u>           | <u>23,833,189</u>   | <u>23,689,866</u>   |

See accompanying notes to consolidated financial statements

**PETMED EXPRESS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

Fiscal years ended March 31, 2004, March 31, 2005 and March 31, 2006

|  | Convertible Preferred Stock |                 | Common Stock      |                  | Additional Paid-In Capital | Retained Earnings (Accumulated Deficit) | Total                |
|--|-----------------------------|-----------------|-------------------|------------------|----------------------------|---|----------------------|
|  | Shares                      | Amounts         | Shares            | Amounts          |                            |   |                      |
| Balance, March 31, 2003                                      | 2,500                       | 8,898           | 18,460,878        | 18,461           | 7,279,207                  | (1,713,878)                             | 5,592,688            |
| Issuance of common stock from exercise of stock options      | -                           | -               | 1,179,596         | 1,179            | 1,285,366                  | -                                       | 1,286,545            |
| Issuance of common stock from exercise of warrants           | -                           | -               | 2,219,583         | 2,220            | 710,580                    | -                                       | 712,800              |
| Tax benefit related to stock options exercised               | -                           | -               | -                 | -                | 588,872                    | -                                       | 588,872              |
| Net income   | -                           | -               | -                 | -                | -                          | 5,813,604                               | 5,813,604            |
| Balance, March 31, 2004                                      | 2,500                       | 8,898           | 21,860,057        | 21,860           | 9,864,025                  | 4,099,726                               | 13,994,509           |
| Issuance of common stock from exercise of stock options      | -                           | -               | 1,058,668         | 1,059            | 1,076,130                  | -                                       | 1,077,189            |
| Issuance of common stock from exercise of warrants and other | -                           | -               | 540,000           | 540              | 215,707                    | -                                       | 216,247              |
| Tax benefit related to stock options exercised               | -                           | -               | -                 | -                | 918,749                    | -                                       | 918,749              |
| Net income   | -                           | -               | -                 | -                | -                          | 8,010,370                               | 8,010,370            |
| Balance, March 31, 2005                                      | 2,500                       | \$ 8,898        | 23,458,725        | \$ 23,459        | \$ 12,074,611              | \$ 12,110,096                           | \$ 24,217,064        |
| Issuance of common stock from exercise of stock options      | -                           | -               | 508,665           | 508              | 1,015,523                  | -                                       | 1,016,031            |
| Tax benefit related to stock options exercised               | -                           | -               | -                 | -                | 342,920                    | -                                       | 342,920              |
| Net income   | -                           | -               | -                 | -                | -                          | 12,063,514                              | 12,063,514           |
| Balance, March 31, 2006                                      | <u>2,500</u>                | <u>\$ 8,898</u> | <u>23,967,390</u> | <u>\$ 23,967</u> | <u>\$ 13,433,054</u>       | <u>\$ 24,173,610</u>                    | <u>\$ 37,639,529</u> |

See accompanying notes to consolidated financial statements

**PETMED EXPRESS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | <b>Year Ended March 31,</b> |               |              |
|---|-----------------------------|---------------|--------------|
|   | <b>2006</b>                 | <b>2005</b>   | <b>2004</b>  |
| <b>Cash flows from operating activities:</b>                                      |                             |               |              |
| Net income  | \$ 12,063,514               | \$ 8,010,370  | \$ 5,813,604 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                             |               |              |
| Depreciation and amortization   | 544,535                     | 573,817       | 550,392      |
| Tax benefit related to stock options exercised                                    | 342,920                     | 918,749       | 588,872      |
| Deferred income taxes   | (211,156)                   | (1,490)       | -            |
| Loss on disposal of property and equipment  | 1,719                       | -             | -            |
| Bad debt expense (recovery)   | (1,709)                     | 16,092        | 7,432        |
| (Increase) decrease in operating assets and increase (decrease) in liabilities:   |                             |               |              |
| Accounts receivable   | 642,684                     | (679,547)     | (488,850)    |
| Inventories - finished goods  | (3,817,342)                 | (475)         | (6,911,712)  |
| Prepaid expenses and other current assets   | (369,886)                   | 19,066        | 245,890      |
| Other assets  | -                           | 7,655         | 178,333      |
| Accounts payable  | 327,963                     | (548,072)     | 702,603      |
| Income taxes payable  | 356,783                     | 179,090       | 251,693      |
| Accrued expenses and other current liabilities                                    | 397,465                     | (146,456)     | 167,338      |
| Net cash provided by operating activities   | 10,277,490                  | 8,348,799     | 1,105,595    |
| <b>Cash flows from investing activities:</b>                                      |                             |               |              |
| Purchases of property and equipment   | (758,176)                   | (171,757)     | (741,740)    |
| Net proceeds from the sale of property and equipment                              | 600                         | -             | -            |
| Net cash used in investing activities   | (757,576)                   | (171,757)     | (741,740)    |
| <b>Cash flows from financing activities:</b>                                      |                             |               |              |
| Proceeds from the exercise of stock options and warrants and other transactions   | 1,016,031                   | 1,293,436     | 1,999,345    |
| Payments on the loan obligation   | -                           | (68,442)      | (68,443)     |
| Net cash provided by financing activities   | 1,016,031                   | 1,224,994     | 1,930,902    |
| Net increase in cash and cash equivalents   | 10,535,945                  | 9,402,036     | 2,294,757    |
| Cash and cash equivalents, at beginning of the year                               | 12,680,962                  | 3,278,926     | 984,169      |
| Cash and cash equivalents, at end of the year                                     | \$ 23,216,907               | \$ 12,680,962 | \$ 3,278,926 |
| <b>Supplemental disclosure of cash flow information:</b>                          |                             |               |              |
| Cash paid for interest  | \$ -                        | \$ 884        | \$ 14,302    |
| Cash paid for income taxes  | \$ 6,483,132                | \$ 3,496,696  | \$ 2,513,214 |

See accompanying notes to consolidated financial statements

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### (1) Summary of Significant Accounting Policies

#### Organization

PetMed Express, Inc. and subsidiaries, d/b/a 1-800-PetMeds, (the "Company") is a leading nationwide pet pharmacy. The Company markets and sells prescription and non-prescription pet medications and other health products for dogs, cats and horses direct to the consumer.

The Company markets its products through national television, on-line and direct mail/print advertising campaigns, which aim to increase the recognition of the "1-800-PetMeds" brand name, increase traffic on its website at [www.1800petmeds.com](http://www.1800petmeds.com), acquire new customers, and maximize repeat purchases. The majority of all of the Company's sales are to residents in the United States. The Company's executive offices are located in Pompano Beach, Florida.

The Company's fiscal year end is March 31. References herein to fiscal 2006, 2005, or 2004 refer to the Company's fiscal years ended March 31, 2006, 2005 and 2004, respectively.

#### Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its two wholly owned subsidiaries. All significant intercompany transactions have been eliminated in consolidation.

#### Revenue Recognition

The Company generates revenue by selling pet medication products primarily to retail consumers and minimally to wholesale customers. The Company's policy is to recognize revenue from product sales upon shipment, when the rights of ownership and risk of loss have passed to the consumer. Outbound shipping and handling fees are included in sales and are billed upon shipment. Shipping expenses are included in cost of sales.

The majority of the Company's sales are paid by credit cards and the Company usually receives the cash settlement in two to three banking days. Credit card sales minimize the accounts receivable balances relative to sales. The Company maintains an allowance for doubtful accounts for losses that the Company estimates will arise from the customers' inability to make required payments, arising from either credit card charge-backs or insufficient funds checks. The Company determines its estimates of the uncollectibility of accounts receivable by analyzing historical bad debts and current economic trends. At March 31, 2006 and 2005 the allowance for doubtful accounts was approximately \$23,000 and \$37,000, respectively.

#### Cash and Cash Equivalents

The Company considers all highly liquid investments with maturity of three months or less when purchased to be cash equivalents. Cash and cash equivalents at March 31, 2006 and 2005, consist of the Company's cash accounts, overnight repurchase agreements, and short-term investments with a maturity of three months or less. The carrying amount of cash equivalents approximates fair value. The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

#### Use of Estimates

The preparation of consolidated 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### (1) Summary of Significant Accounting Policies (Continued)

#### **Inventories**

Inventories consist of prescription and non-prescription pet medications and pet supplies that are available for sale and are priced at the lower of cost or market value using a weighted average cost method. The Company writes down its inventory for estimated obsolescence. The inventory reserve was approximately \$306,000 and \$228,000 at March 31, 2006 and 2005, respectively.

#### **Property and Equipment**

Property and equipment are stated at cost and depreciated using the straight-line method over the estimated useful lives of the assets. The furniture, fixtures, equipment and computer software are depreciated over periods ranging from three to seven years. Leasehold improvements and assets under capital lease agreements are amortized over the shorter of the underlying lease agreement or the useful life of the asset.

#### **Long-lived Assets**

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Recoverability of assets is measured by a comparison of the carrying amount of the asset to net future cash flows expected to be generated from the asset.

#### **Intangible Asset**

The intangible asset consists of a toll-free telephone number. In accordance with the Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets*, the intangible asset is not being amortized, and is subject to an annual review for impairment.

#### **Advertising**

The Company's advertising expenses consists primarily of television advertising, internet marketing, and direct mail/print advertising. Television costs are expensed as the advertisements are televised. Internet costs are expensed in the month incurred and direct mail/print advertising costs are expensed when the related catalog and postcards are produced, distributed or superseded.

#### **Fair Value of Financial Instruments**

The carrying amounts of the Company's cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the short-term nature of these instruments. The carrying amount of the loan payable approximated fair value as their interest rates approximated current market rates.

#### **Comprehensive Income**

The Company applies SFAS No. 130, *Reporting Comprehensive Income*, which requires that all items that are recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. The items of other comprehensive income that are typically required to be displayed are foreign currency items, minimum pension liability adjustments and unrealized gains and losses on certain investments in debt and equity securities. There were no items of other comprehensive income for any periods presented herein.

#### **Income Taxes**

The Company accounts for income taxes under the provisions of SFAS No. 109, *Accounting for Income Taxes*, which generally requires recognition of deferred tax assets and liabilities for the expected future tax benefits or consequences of events that have been included in the consolidated financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting carrying values and the tax bases of assets and liabilities, and are measured by applying enacted tax rates and laws for the taxable years in which those differences are expected to reverse.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### (1) Summary of Significant Accounting Policies (Continued)

#### Accounting for Stock-Based Compensation

The Company accounts for employee stock options using the intrinsic value method as prescribed by Accounting Principles Board Opinion (“APB”) No. 25, *Accounting for Stock Issued to Employees*. The Company follows the disclosure provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, for employee stock options. Had the Company determined employee compensation cost based on the fair value at the grant date for its stock options under SFAS No. 123, the Company’s net income would have been decreased to the pro forma amounts indicated below:

| <u>Year Ended March 31,</u>   | <u>2006</u>          | <u>2005</u>         | <u>2004</u>         |
|---|----------------------|---------------------|---------------------|
| Reported net income:  | \$ 12,063,514        | \$ 8,010,370        | \$ 5,813,604        |
| Deduct: total stock-based employee compensation expense determined under fair-value based method for all awards, net of related tax effects | <u>596,434</u>       | <u>501,244</u>      | <u>289,907</u>      |
| Pro forma net income:   | <u>\$ 11,467,080</u> | <u>\$ 7,509,126</u> | <u>\$ 5,523,697</u> |
| Reported basic net income per share:  | <u>\$ 0.51</u>       | <u>\$ 0.35</u>      | <u>\$ 0.30</u>      |
| Pro forma basic net income per share:   | <u>\$ 0.48</u>       | <u>\$ 0.33</u>      | <u>\$ 0.28</u>      |
| Reported diluted net income per share:  | <u>\$ 0.50</u>       | <u>\$ 0.34</u>      | <u>\$ 0.25</u>      |
| Pro forma diluted net income per share:   | <u>\$ 0.48</u>       | <u>\$ 0.32</u>      | <u>\$ 0.23</u>      |

The per share weighted-average fair value of stock options granted during fiscal 2006, 2005, and 2004 was \$3.51, \$5.45, and \$4.13, respectively, on the date of grant using the Black Scholes option-pricing model, as prescribed by SFAS No. 123, with the following weighted-average assumptions: no dividend yield; risk-free interest rates ranging from 4 to 6 percent; expected lives of 3-5 years, and expected volatility of 66 percent, 86 percent, and 68 percent, respectively.

#### Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R, *Share Based Payment*, which is a revision of SFAS No. 123. This Statement supersedes APB No. 25, which is the basis for the Company’s current policy on accounting for stock-based compensation. SFAS No. 123R will require companies to recognize as an expense in the Statement of Income the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS No. 123R is effective for the Company as of April 1, 2006, the beginning of the quarter ending June 30, 2006. Under the methods of adoption allowed by the standard, awards that are granted, modified, or settled after the date of adoption should be measured and accounted for in accordance with SFAS No. 123R. The fair value of unvested equity-classified awards that were granted prior to the effective date should be measured in accordance with SFAS No. 123 and recognized as compensation expense in the Statement of Income.

Previously reported amounts may be restated for all periods presented or adopted at the beginning of the fiscal year to reflect the SFAS No. 123R amounts in the Statement of Income. Pro forma disclosures about the fair value method and the impact on net income and net income per common share appear in the above table. The Company is evaluating the requirements of SFAS No. 123R and expects that the adoption of SFAS No. 123R may have a material impact on its consolidated statements of income and earnings per share, similar to the current pro forma disclosures under FAS 123 as per above.

The Company does not believe that any other recently issued, but not yet effective, accounting standard, if currently adopted, will have a material effect on the Company’s consolidated financial position, results of operations or cash flows.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### (2) Property and Equipment

Major classifications of property and equipment consist of the following:

|   | March 31,    |              |
|---|--------------|--------------|
|   | 2006         | 2005         |
|   | \$           | \$           |
| Leasehold improvements                          | 409,164      | 384,445      |
| Computer software                               | 427,447      | 391,197      |
| Furniture, fixtures and equipment               | 2,456,695    | 2,361,438    |
| Equipment and software under capital lease      | -            | 113,398      |
|   | 3,293,306    | 3,250,478    |
| Less: accumulated depreciation and amortization | (1,795,717)  | (1,964,211)  |
| Property and equipment, net                     | \$ 1,497,589 | \$ 1,286,267 |

Amortization expense for equipment and software under capital leases was approximately \$0, \$10,000, and \$35,000, for the years ended March 31, 2006, 2005, and 2004, respectively.

### (3) Accrued Expenses and Other Liabilities

Major classifications of accrued expenses and other liabilities consist of the following:

|  | March 31,  |            |
|--|------------|------------|
|  | 2006       | 2005       |
| Accrued professional expenses          | \$ 300,500 | \$ 126,250 |
| Accrued credit card fees               | 232,022    | 39,880     |
| Accrued salaries and benefits          | 170,846    | 96,017     |
| Accrued advertising expenses           | 99,000     | 177,000    |
| Other accrued liabilities              | 170,991    | 136,747    |
| Accrued expenses and other liabilities | \$ 973,359 | \$ 575,894 |

### (4) Line of Credit Agreement

The Company's \$6,000,000 line of credit, which upon 30 days notice had a provision to increase the line to \$7,500,000, was effective through November 2, 2005. On October 31, 2005, the Company and RBC Centura Bank ("RBC") agreed to extend the maturity date of the existing line of credit for a period of 90 days. On February 3, 2006, the Company and RBC agreed to extend the maturity date of the existing line of credit for an additional 45 days. The Company determined that it no longer had a need for this line of credit and it was not renewed.

### (5) Shareholders' Equity

#### Preferred Stock

In April 1998, the Company issued 250,000 shares of its \$.001 par value preferred stock at a price of \$4.00 per share, less issuance costs of \$112,187. Each share of the preferred stock is convertible into approximately 4.05 shares of common stock at the election of the shareholder. The shares have a liquidation value of \$4.00 per share and may pay dividends at the sole discretion of the Company. The Company does not anticipate paying dividends to the preferred shareholders in the foreseeable future. Each share of preferred stock is entitled to one vote on all matters submitted to a vote of shareholders of the Company. As of March 31, 2006 and 2005, 2,500 shares of the convertible preferred stock remained unconverted and outstanding.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### (6) Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The tax effects of temporary differences that give rise to significant portions of deferred tax assets and deferred tax liabilities are as follows:

|                                 | March 31,         |                   |
|---------------------------------|-------------------|-------------------|
|                                 | <u>2006</u>       | <u>2005</u>       |
| Deferred tax assets:            |                   |                   |
| Bad debt and inventory reserves | \$ 123,991        | \$ 97,941         |
| Accrued expenses                | 233,644           | 132,095           |
| Net operating loss carryforward | <u>1,139,232</u>  | <u>1,218,715</u>  |
| Deferred tax assets             | 1,496,867         | 1,448,751         |
| Less: valuation allowance       | <u>(638,066)</u>  | <u>(717,549)</u>  |
| Total deferred tax assets       | 858,801           | 731,202           |
| Deferred tax liabilities:       |                   |                   |
| Depreciation                    | <u>(64,799)</u>   | <u>(148,356)</u>  |
| Total net deferred taxes        | <u>\$ 794,002</u> | <u>\$ 582,846</u> |

The change in the valuation allowance for the years ended March 31, 2006 and 2005 was approximately \$79,000 and \$86,000, respectively. At March 31, 2006, the Company had net operating loss carryforwards of approximately \$3,027,000. The net operating loss carryforwards expire in the years 2013 through 2020. The use of such net operating loss carryforwards is limited to approximately \$266,000 annually due to the November 22, 2000 change of control.

The components of the income tax provision consist of the following:

|                                  | Year Ended March 31, |                     |                     |
|----------------------------------|----------------------|---------------------|---------------------|
|                                  | <u>2006</u>          | <u>2005</u>         | <u>2004</u>         |
| Current taxes                    |                      |                     |                     |
| Federal                          | \$ 6,114,087         | \$ 3,911,564        | \$ 2,902,988        |
| State                            | <u>1,046,607</u>     | <u>682,971</u>      | <u>496,933</u>      |
| Total current taxes              | <u>7,160,694</u>     | <u>4,594,535</u>    | <u>3,399,921</u>    |
| Deferred taxes                   |                      |                     |                     |
| Federal                          | (161,388)            | (1,490)             | -                   |
| State                            | <u>(27,626)</u>      | <u>-</u>            | <u>-</u>            |
| Total deferred taxes             | <u>(189,014)</u>     | <u>(1,490)</u>      | <u>-</u>            |
| Total provision for income taxes | <u>\$ 6,971,680</u>  | <u>\$ 4,593,045</u> | <u>\$ 3,399,921</u> |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### (6) Income Taxes (Continued)

The reconciliation of income tax provision computed at the U.S. federal statutory tax rates to income tax expense is as follows:

|  | Year Ended March 31, |                     |                     |
|--|----------------------|---------------------|---------------------|
|  | <u>2006</u>          | <u>2005</u>         | <u>2004</u>         |
| Income taxes at U.S. statutory rates           | \$ 6,471,966         | \$ 4,285,161        | \$ 3,132,599        |
| State income taxes, net of federal tax benefit | 690,978              | 457,504             | 334,451             |
| Permanent differences                          | (186,470)            | 9,178               | 992                 |
| Other  | 74,689               | (72,445)            | 66,743              |
| Change in valuation allowance                  | <u>(79,483)</u>      | <u>(86,353)</u>     | <u>(134,864)</u>    |
| Total provision for income taxes               | <u>\$ 6,971,680</u>  | <u>\$ 4,593,045</u> | <u>\$ 3,399,921</u> |

### (7) Stock Options and Warrants

#### Stock Options Granted to Employees

The Company established the 1998 Stock Option Plan (the "Plan") effective July 31, 1998, which provides for the issuance of qualified options to officers and key employees, and nonqualified options to directors, consultants and other service providers. The Company has reserved 5,000,000 shares of common stock for issuance under the Plan. The exercise prices of options issued under the Plan must be equal to or greater than the market price of the Company's common stock as of the date of issuance. The Company had 851,170 and 1,166,002 options outstanding under the Plan at March 31, 2006 and 2005, respectively. In addition the Company issued options prior to July 31, 1998, which are not included in the Plan.

A summary of the status of stock options and certain warrants issued by the Company, together with changes during the periods indicated, is presented in the following table:

|                           | <u>Options</u>  | <u>Weighted-<br/>average<br/>exercise price</u> |
|---------------------------|-----------------|---|
| Balance at March 31, 2003 | 2,743,600       | 1.06  |
| Options Granted           | 455,500         | 7.94  |
| Options Exercised         | (1,179,596)     | 1.09  |
| Options Canceled          | <u>(167)</u>    | <u>4.50</u>                                     |
| Balance at March 31, 2004 | 2,019,337       | 2.60  |
| Options Granted           | 230,500         | 8.18  |
| Options Exercised         | (1,058,668)     | 1.02  |
| Options Canceled          | <u>(25,167)</u> | <u>4.66</u>                                     |
| Balance at March 31, 2005 | 1,166,002       | 5.10  |
| Options Granted           | 200,500         | 6.60  |
| Options Exercised         | (508,665)       | 2.00  |
| Options Canceled          | <u>(6,667)</u>  | <u>6.72</u>                                     |
| Balance at March 31, 2006 | <u>851,170</u>  | <u>\$ 7.28</u>                                  |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(7) Stock Options and Warrants (Continued)**

The following table summarizes information for options currently outstanding and exercisable at March 31, 2006:

| Exercise<br>Price Range  | Options Outstanding |   |   | Options Exercisable |   |
|--------------------------|---------------------|---|---|---------------------|---|
|                          | Number              | Weighted-<br>average<br>Remaining<br>Life | Weighted-<br>average<br>Exercise<br>Price | Number              | Weighted-<br>average<br>Exercise<br>Price |
| \$1.05 - \$1.90          | 136,666             | 1.62 years                                | \$ 1.23                                   | 136,666             | \$ 1.23                                   |
| 3.45 - 6.50              | 37,169              | 3.18 years                                | 3.45                                      | 13,335              | 3.45                                      |
| 6.60 - 7.90              | 240,500             | 3.31 years                                | 6.67                                      | 13,333              | 7.03                                      |
| 8.00 - 10.64             | 436,835             | 3.31 years                                | 9.84                                      | 227,500             | 10.11                                     |
| <u>\$ 1.05 - \$10.64</u> | <u>851,170</u>      | <u>3.07 years</u>                         | <u>\$ 7.28</u>                            | <u>390,834</u>      | <u>\$ 6.67</u>                            |

At March 31, 2006 and 2005, the number of options exercisable was 390,834 and 546,834, respectively, and the weighted-average exercise price of those options was \$6.67 and \$2.96, respectively. Adjustments are made for options forfeited prior to vesting.

**Warrants**

On November 22, 2000, Tricon Holdings, LLC, a Florida limited liability corporation ("Tricon"), acquired 10,000,000 shares of the Company's authorized and unissued shares of common stock and warrants to purchase 3,000,000 shares of the Company's authorized and unissued shares of common stock. The warrants were exercisable at \$.33 per share and were assigned a value of \$601,260 using the Black Scholes option-pricing model, as prescribed by SFAS No. 123, with the following weighted-average assumptions: dividend yield 0.0 percent; risk-free interest rates of 6.00 percent; expected lives of 3-5 years, and expected volatility of 91 percent. As of March 31, 2005 all of the 3,000,000 warrants issued on November 22, 2000 were exercised.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### (8) Net Income Per Share

In accordance with the provisions of SFAS No. 128, "Earnings Per Share," basic net income per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted net income per share includes the dilutive effect of potential stock issuances, calculated using the treasury stock method. Outstanding stock options, warrants, and convertible preferred shares issued by the Company represent the only dilutive effect reflected in diluted weighted average shares outstanding. The following is a reconciliation of the numerators and denominators of the basic and diluted net income per share computations for the periods presented:

|   | <b>Year Ended March 31,</b> |                          |                          |
|---|-----------------------------|--------------------------|--------------------------|
|   | <b><u>2006</u></b>          | <b><u>2005</u></b>       | <b><u>2004</u></b>       |
| Net income (numerator):   |                             |                          |                          |
| Net income  | \$ <u>12,063,514</u>        | \$ <u>8,010,370</u>      | \$ <u>5,813,604</u>      |
| Shares (denominator)  |                             |                          |                          |
| Weighted average number of common shares<br>outstanding used in basic computation | 23,658,722                  | 22,862,417               | 19,471,681               |
| Common shares issuable upon exercise<br>of stock options and warrants             | 543,108                     | 960,647                  | 4,208,060                |
| Common shares issuable upon conversion<br>of preferred shares                     | <u>10,125</u>               | <u>10,125</u>            | <u>10,125</u>            |
| Shares used in diluted computation  | <u><u>24,211,955</u></u>    | <u><u>23,833,189</u></u> | <u><u>23,689,866</u></u> |
| Net income per common share:  |                             |                          |                          |
| Basic   | \$ <u>0.51</u>              | \$ <u>0.35</u>           | \$ <u>0.30</u>           |
| Diluted   | \$ <u><u>0.50</u></u>       | \$ <u><u>0.34</u></u>    | \$ <u><u>0.25</u></u>    |

At March 31, 2006, all common stock options were included in the diluted net income per share computation as their exercise prices were less than the average market price of the common shares for the period. At March 31, 2005 and 2004, 485,500 and 305,000 common stock options, respectively, with a weighted average exercise price of \$9.69 and \$10.16, respectively, were excluded from the diluted net income per share computation as their exercise prices were greater than the average market price of the common shares for the period, therefore the effect would have been anti-dilutive.

### (9) Valuation and Qualifying Accounts

Activity in the Company's valuation and qualifying accounts consists of the following:

|  | <b>Year Ended March 31,</b> |                       |                       |
|--|-----------------------------|-----------------------|-----------------------|
|  | <b><u>2006</u></b>          | <b><u>2005</u></b>    | <b><u>2004</u></b>    |
| Allowance for doubtful accounts:               |                             |                       |                       |
| Balance at beginning of period                 | \$ 36,535                   | \$ 22,987             | \$ 16,644             |
| Provision (recovery) for doubtful accounts     | (1,709)                     | 16,092                | 7,702                 |
| Write-off of uncollectible accounts receivable | <u>(11,400)</u>             | <u>(2,544)</u>        | <u>(1,359)</u>        |
| Balance at end of period                       | <u><u>23,426</u></u>        | <u><u>36,535</u></u>  | <u><u>22,987</u></u>  |
| Valuation allowance for deferred tax assets:   |                             |                       |                       |
| Balance at beginning of period                 | \$ 717,549                  | \$ 803,902            | \$ 938,766            |
| (Deletions) / additions                        | <u>(79,483)</u>             | <u>(86,353)</u>       | <u>(134,864)</u>      |
| Balance at end of period                       | <u><u>638,066</u></u>       | <u><u>717,549</u></u> | <u><u>803,902</u></u> |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### (10) Commitments and Contingencies

#### Legal Matters

The Company is a defendant in a lawsuit, filed in August 2002, in Texas state district court seeking injunctive and monetary relief styled Texas State Board of Pharmacy and State Board of Veterinary Medical Examiners v. PetMed Express, Inc. Cause No. GN-202514, in the 201st Judicial District Court, Travis County, Texas. The Company in its initial pleading denied the allegations contained therein. The Company is vigorously defending, is confident of its compliance with the applicable law, and finds wrong-on-the-facts the vast majority of the allegations contained in the Plaintiffs' supporting documentation attached to the lawsuit. We are currently negotiating a settlement of the matter, although there can be no assurances that the negotiations will be successful. Thus, at this stage it is difficult to assess the outcome or estimate any potential loss in the event of an adverse outcome.

On January 19, 2006, PetMed Express, Inc. was added as a defendant in the matter of Yali Golan v. Marc Puleo (former President and current Chairman of the Board of Directors of the Company), filed in the Circuit Court of the Eleventh Judicial Circuit in and for Miami-Dade County, Florida which had originally been filed solely against Dr. Puleo in March 2003. This action is based upon allegations by the plaintiff that Dr. Puleo individually entered into a written agreement with the plaintiff (the purported "General Agreement," of which the plaintiff has not produced an original document) which in pertinent part granted plaintiff 50% of any salary, stock or stock options received by Dr. Puleo from the Company for so long as the Company remains in business. The plaintiff now alleges that the Company's past and continuing failure to disclose the purported General Agreement in filings with the SEC has caused the plaintiff to suffer damages. The plaintiff is seeking a judgment against the Company for specific performance and unspecified damages, pre- and post-judgment interest, court fees and such other relief as the court deems appropriate. The Company believes that, based on information currently available to it, the claims being asserted against it are factually and legally without merit, and the Company intends to vigorously defend against such claims.

#### Routine Proceedings

The Company is a party to routine litigation and administrative complaints incidental to its business. Management does not believe that the resolution of any or all of such routine litigation and administrative complaints is likely to have a material adverse effect on the Company's financial condition or results of operations. The Company has settled complaints that had been filed with various states' pharmacy boards in the past. There can be no assurances made that other states will not attempt to take similar actions against the Company in the future. Legal costs related to the above matters are expensed as incurred.

#### Employment Agreements

On March 16, 2001, the Company entered into an employment agreement with its Chief Executive Officer ("CEO"), Menderes Akdag ("Mr. Akdag"). Under the terms of this three-year agreement the Company paid the CEO an annual salary of \$150,000 for the first six months of the agreement, and thereafter his annual salary was increased to \$200,000. The Company also granted the CEO options to purchase 750,000 shares of its common stock under the Company's 1998 Stock Option Plan at an exercise price of \$.32 per share, which vested at the rate of 187,500 options on each of March 16, 2001, 2002, 2003 and 2004.

On March 16, 2004, the Company amended the CEO's existing employment agreement. The amendments are as follows: the term of the agreement was for three years, commencing on March 16, 2004; Mr. Akdag's salary was increased to \$250,000 per year throughout the term of the agreement, and Mr. Akdag was granted 250,000 incentive stock options under the Company's 1998 Stock Option Plan at an exercise price of \$10.64 per share, which vest at the rate of 83,333 options on each of March 16, 2005 and 2006, and 83,334 options on March 16, 2007.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### (10) Commitments and Contingencies (Continued)

#### Operating Lease

The Company leases its executive offices and warehouse facility under a non-cancelable operating lease. The Company is responsible for certain maintenance costs, taxes and insurance under this lease. On May 18, 2005 the Company signed an amendment to extend the current lease agreement through May 31, 2009. The amendment terms are similar to the existing lease agreement, and the Company exercised its option to lease an additional 3,600 square feet. On November 28, 2005 the Company signed a fourth amendment to its current lease agreement. The Company agreed to lease an additional 7,000 square feet to expand its warehouse and pharmacy. This addition to the warehouse and pharmacy was necessary to increase the Company's capacity to store additional inventory and expand its fulfillment operations. Under the terms of the new amendments the Company will be leasing a total 50,000 square feet through May 31, 2009. The future minimum annual lease payments are as follows:

#### Years Ending March 31,

|                      |                     |
|----------------------|---------------------|
| 2007                 | 481,000             |
| 2008                 | 500,000             |
| 2009                 | 520,000             |
| 2010                 | <u>87,000</u>       |
| Total lease payments | <u>\$ 1,588,000</u> |

Rent expense was \$435,000, \$383,000 and \$330,000 for the years ended March 31, 2006, 2005 and 2004, respectively.

### (11) Sales by Category

The following table provides a breakdown of the percentage of our total sales by each category during the indicated periods:

|   | Year Ended March 31, |             |             |
|---|----------------------|-------------|-------------|
|   | <u>2006</u>          | <u>2005</u> | <u>2004</u> |
| Prescription medications                | 29%                  | 30%         | 30%         |
| Non-prescription medications            | 70%                  | 69%         | 69%         |
| Shipping and handling charges and other | 1%                   | 1%          | 1%          |
| Total                                   | <u>100%</u>          | <u>100%</u> | <u>100%</u> |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(12) Quarterly Financial Data (Unaudited)**

Summarized unaudited quarterly financial data for fiscal 2006 and 2005 is as follows:

| <u>Quarter Ended:</u>               | <u>June 30, 2005</u> |            | <u>September 30, 2005</u> |            | <u>December 31, 2005</u> |            | <u>March 31, 2006</u> |            |
|-------------------------------------|----------------------|------------|---------------------------|------------|--------------------------|------------|-----------------------|------------|
| Sales                               | \$                   | 43,631,758 | \$                        | 38,652,674 | \$                       | 25,890,095 | \$                    | 29,408,628 |
| Gross Profit                        | \$                   | 16,858,586 | \$                        | 14,850,852 | \$                       | 10,276,380 | \$                    | 12,352,971 |
| Income from operations              | \$                   | 5,273,844  | \$                        | 3,987,598  | \$                       | 3,891,063  | \$                    | 4,992,739  |
| Net income                          | \$                   | 3,541,586  | \$                        | 2,710,826  | \$                       | 2,672,092  | \$                    | 3,139,010  |
| Diluted net income per common share | \$                   | 0.15       | \$                        | 0.11       | \$                       | 0.11       | \$                    | 0.13       |

| <u>Quarter Ended:</u>               | <u>June 30, 2004</u> |            | <u>September 30, 2004</u> |            | <u>December 31, 2004</u> |            | <u>March 31, 2005</u> |            |
|-------------------------------------|----------------------|------------|---------------------------|------------|--------------------------|------------|-----------------------|------------|
| Sales                               | \$                   | 35,288,528 | \$                        | 28,754,697 | \$                       | 20,782,837 | \$                    | 23,531,685 |
| Gross Profit                        | \$                   | 13,861,809 | \$                        | 11,613,141 | \$                       | 8,445,527  | \$                    | 9,737,268  |
| Income from operations              | \$                   | 2,726,016  | \$                        | 2,856,588  | \$                       | 3,129,631  | \$                    | 3,789,391  |
| Net income                          | \$                   | 1,818,138  | \$                        | 1,811,655  | \$                       | 1,957,111  | \$                    | 2,423,466  |
| Diluted net income per common share | \$                   | 0.08       | \$                        | 0.08       | \$                       | 0.08       | \$                    | 0.10       |

## REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of the Company is responsible for the preparation and integrity of the Consolidated Financial Statements appearing in our Annual Report on Form 10-K. The financial statements were prepared in conformity with generally accepted accounting principles appropriate in the circumstances and, accordingly, include certain amounts based on our best judgments and estimates. Financial information in the Annual report of Form 10-K is consistent with that in the financial statements.

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) under the Securities Exchange Act of 1934 (“Exchange Act”). The Company’s internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Consolidated Financial Statements. Our internal control over financial reporting is supported by a team of consultants and appropriate reviews by management, written policies and guidelines, careful selection and training of qualified personnel and a written Corporate Code of Business Conduct and Ethics adopted by our Company’s Board of Directors, applicable to all Company Directors and all officers and employees of our Company and subsidiaries.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and even when determined to be effective, can only provide reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Audit Committee (“Committee”) of our Company’s Board of Directors, comprised solely of Directors who are independent in accordance with the requirements of the Nasdaq National Market listing standards, the Exchange Act and the Company’s Corporate Governance Guidelines, meets with the independent auditors and management periodically to discuss internal control over financial reporting and auditing and financial reporting matters. The Committee reviews with the independent auditors the scope and results of the audit effort. The Committee also meets periodically with the independent auditors without management present to ensure that the independent auditors have free access to the Committee. Our Audit Committee’s Report can be found in the Company’s 2006 Proxy Statement.

Management assessed the effectiveness of the Company’s internal control over financial reporting as of March 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control – Integrated Framework*. Based on our assessment, management believes that the Company maintained effective internal control over financial reporting as of March 31, 2006,

The Company’s independent auditors, Goldstein Golub Kessler LLP, a registered public accounting firm, are appointed by the Audit Committee of the Company’s Board of Directors, subject to ratification by our Company’s shareholders. Goldstein Golub Kessler LLP have audited and reported on the Consolidated Financial Statements of PetMed Express, Inc. and subsidiaries, management’s assessment of the effectiveness of the Company’s internal control over financial reporting and the effectiveness of the Company’s management’s assessment of the effectiveness of our internal control over financial reporting. The reports of the independent auditors are contained in this annual report.

/s/ Menderes Akdag

Menderes Akdag

Chief Executive Officer, President, Director

May 11, 2006

/s/ Bruce S. Rosenbloom

Bruce S. Rosenbloom

Chief Financial Officer

May 11, 2006

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The Board of Directors and Stockholders  
PetMed Express, Inc.:

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

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

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that PetMed Express, Inc. maintained effective internal control over financial reporting as of March 31, 2006 is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, PetMed Express, Inc. maintained, in all material respects, effective internal control over financial reporting as of March 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the March 31, 2006 consolidated financial statements of PetMed Express, Inc. and our report dated May 11, 2006 expressed an unqualified opinion on those financial statements.

/s/ Goldstein Golub Kessler LLP  
Goldstein Golub Kessler LLP

New York, New York  
May 11, 2006

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Not applicable.

**ITEM 9A. CONTROLS AND PROCEDURES**

The Company's management, including our Chief Executive Officer and Chief Financial Officer, has conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-14(c) promulgated under the Securities Exchange Act of 1934, as amended) as of the year ended March 31, 2006, the end of the period covered by this report (the "Evaluation Date"). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective for timely gathering, analyzing and disclosing the information we are required to disclose in our reports filed under the Securities Exchange Act of 1934, as amended. There have been no significant changes made in our internal controls or in other factors that could significantly affect our internal controls over financial reporting during the period covered by this report.

**ITEM 9B. OTHER INFORMATION**

Not applicable.

### PART III

#### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this item will be set forth in our Proxy Statement relating to our 2006 Annual Meeting of Stockholders to be held on July 28, 2006, and is incorporated herein by reference.

#### ITEM 11. EXECUTIVE COMPENSATION

The information required by this item will be set forth in our Proxy Statement relating to our 2006 Annual Meeting of Stockholders to be held on July 28, 2006, and is incorporated herein by reference.

#### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item (other than information required by Item 201(d) of Regulation S-K with respect to equity compensation plans, which is set forth below in this Annual Report on Form 10-K) will be set forth in our Proxy Statement relating to our 2006 Annual Meeting of Stockholders to be held on July 28, 2006, and is incorporated herein by reference.

##### *Securities Authorized for Issuance under Equity Compensation Plans*

The following table sets forth securities authorized for issuance under equity compensation plans, including individual compensation arrangements, by us under our 1998 Stock Option Plan and any compensation plans not previously approved by our Board of Directors as of March 31, 2006:

##### EQUITY COMPENSATION PLAN INFORMATION

| <b>Plan category</b>   | <b>Number of securities to be issued upon exercise of outstanding options, warrants and rights</b> | <b>Weighted average exercise price of outstanding options, warrants and rights</b> | <b>Number of securities remaining available for future issuance</b> |
|--|--|--|---|
|  | (a)  | (b)  | (c)   |
| 1998 Stock Option Plan   | 846,170  | \$7.32   | 810,068   |
| Equity compensation plans not approved by security holders (1) | <u>5,000</u>   | \$1.33   | <u>-</u>  |
| Total  | <u><u>851,170</u></u>  |  | <u><u>810,068</u></u>   |

(1) Represents non-plan options to purchase an aggregate of 5,000 common stock options issued to a member of our management, prior to 1998.

#### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item will be set forth in our Proxy Statement relating to our 2006 Annual Meeting of Stockholders to be held on July 28, 2006, and is incorporated herein by reference.

#### ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this item will be set forth in our Proxy Statement relating to our 2006 Annual Meeting of Stockholders to be held on July 28, 2006, and is incorporated herein by reference.

## PART IV

### ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this report on Form 10-K.

**(1) Consolidated Financial Statements**

The following exhibits are filed as part of this report on Form 10-K.

**(3) Articles of Incorporation and By-Laws**

- 3.1 Amended and Restated Articles of Incorporation (1)
- 3.2 By-Laws of the Corporation (1)

**(4) Instruments Defining the Rights of Security Holders**

- 4.1 Form of Warrant issued to Noble International Investments, Inc. (1)
- 4.2 Specimen common stock certificate (1)

**(10) Material Contracts** (\*Management contract or compensatory plan or arrangement.)

- 10.1 Second Amended and Restated Employment Agreement with Marc A. Puleo (incorporated by reference to Exhibit 10.1 of the Registrant's Annual Report on Form 10-KSB for the fiscal year ended March 31, 2000, Commission File No. 000-28827).\*
- 10.2 1998 Stock Option Plan (1)\*
- 10.3 Line of Credit Agreement with SouthTrust Bank, N.A. (1)
- 10.4 Employment Agreement with Menderes Akdag (incorporated by reference to Exhibit 10 of the Registrant's Form 8-K on March 16, 2001, Commission File No. 000-28827).\*
- 10.5 Agreement for the Sale and Leaseback of the Land and Building (incorporated by reference to Exhibit 99.1 of the Registrant's Form 8-K on June 14, 2001, Commission File No. 000-28827).
- 10.6 Line of Credit Renewal Agreement with SouthTrust Bank, N.A. (1).
- 10.7 Loan Agreement with SouthTrust Bank, N.A. (1).
- 10.8 Second Line of Credit (\$1,000,000) Agreement with SouthTrust Bank, N.A. (1).
- 10.9 Third Line of Credit (\$2,000,000) Agreement with SouthTrust Bank, N.A. (1).
- 10.10 Amendment to Third Line of Credit (\$5,000,000) Agreement with SouthTrust Bank, N.A. (incorporated by reference to Exhibit 10.10 of the Registrant's Form 10-Q on November 7, 2003, Commission File No. 000-28827).
- 10.11 Amendment Number 1 to Executive Employment Agreement with Menderes Akdag (incorporated by reference to Exhibit 99.1 of the Registrant's Form 8-K on March 16, 2004, Commission File No. 000-28827).\*
- 10.12 Line of Credit (\$6,000,000) Agreement with RBC Centura Bank. (incorporated by reference to Exhibit 10.12 of the Registrant's Form 10-Q on November 5, 2005, Commission File No. 000-28827).
- 10.13 Termination of Marc Puleo's Executive Employment Agreement (incorporated by reference to Exhibit 10.13 of the Registrant's Form 8-K on August 1, 2005, Commission File No. 000-28827).\*

**(14) Corporate Code of Ethics**

- 14.1 Corporate Code of Ethics (incorporated by reference in our definitive Proxy Statement for our 2004 Annual Meeting of Stockholders held on August 6, 2004).

**(21) Subsidiaries of Registrant**

- 21.1 Subsidiaries of Registrant (filed herewith).

**(31) Certifications**

- 31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, promulgated under the Securities Exchange Act of 1934, as amended (filed herewith to Exhibit 31.1 of the Registrant's Report on Form 10-K for the year ended March 31, 2006, Commission File No. 000-28827).
- 31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, promulgated under the Securities Exchange Act of 1934, as amended (filed herewith to Exhibit 31.2 of the Registrant's Report on Form 10-K for the year ended March 31, 2006, Commission File No. 000-28827).

**(32) Certifications**

- 32.1 Certification Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith to Exhibit 32.1 of the Registrant's Report on Form 10-K for the year ended March 31, 2006, Commission File No. 000-28827).
- (1) Incorporated by reference to the Registration Statement on Form 10-SB, File No. 000-28827, as amended, as filed with the Securities and Exchange Commission.

## SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: May 31, 2006

**PETMED EXPRESS, INC.**  
(the "Registrant")

By: /s/ Menderes Akdag  
Menderes Akdag  
Chief Executive Officer and President  
(principal executive officer)

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on May 31, 2006.

| <b>SIGNATURE</b>  | <b>TITLE</b>   |
|---|--|
| <u>/s/ Menderes Akdag</u><br>Menderes Akdag             | Chief Executive Officer and President<br>(principal executive officer)<br>Officer and Director   |
| <u>/s/ Marc Puleo, M.D.</u><br>Marc Puleo, M.D.         | Chairman of the Board<br>Director  |
| <u>/s/ Bruce S. Rosenbloom</u><br>Bruce S. Rosenbloom   | Chief Financial Officer and Treasurer<br>(principal financial and accounting officer)<br>Officer |
| <u>/s/ Robert C. Schweitzer</u><br>Robert C. Schweitzer | Director   |
| <u>/s/ Ronald J. Korn</u><br>Ronald J. Korn             | Director   |
| <u>/s/ Gian Fulgoni</u><br>Gian Fulgoni                 | Director   |
| <u>/s/ Frank J. Formica</u><br>Frank J. Formica         | Director   |

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

I, Menderes Akdag, Chief Executive Officer and President of PetMed Express, Inc., certify that:

1. I have reviewed this Annual Report on Form 10-K of PetMed Express, Inc.;
2. Based on my knowledge, this Annual Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Annual Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Annual Report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this Annual Report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designated under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Annual Report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Annual Report based on such evaluation; and
  - d) Disclosed in this Annual Report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an Annual Report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of the internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

May 31, 2006

By: /s/ Menderes Akdag  
Menderes Akdag  
Chief Executive Officer and President

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

I, Bruce S. Rosenbloom, Chief Financial Officer of PetMed Express, Inc, certify that:

1. I have reviewed this Annual Report on Form 10-K of PetMed Express, Inc.;
2. Based on my knowledge, this Annual Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Annual Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Annual Report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this Annual Report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designated under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Annual Report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Annual Report based on such evaluation; and
  - d) Disclosed in this Annual Report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an Annual Report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of the internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

May 31, 2006

By: /s/ Bruce S. Rosenbloom  
Bruce S. Rosenbloom  
Chief Financial Officer

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Menderes Akdag, Chief Executive Officer and President (principal executive officer) and I, Bruce S. Rosenbloom, Chief Financial Officer (principal financial officer) of PetMed Express, Inc. (the "Registrant"), each certify to the best of our knowledge, based upon a review of the Annual Report on Form 10-K for the year ended March 31, 2006 (the "Report") of the Registrant, that:

- (1) the Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the Report, fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

Date: May 31, 2006

By: /s/ Menderes Akdag  
Menderes Akdag  
Chief Executive Officer and President

By: /s/ Bruce S. Rosenbloom  
Bruce S. Rosenbloom  
Chief Financial Officer

**SUBSIDIARIES OF PETMED EXPRESS, INC.**

PetMed Express, Inc. directly owns all of the outstanding interests in the following subsidiaries:

Southeastern Veterinary Exports, Inc., a Florida corporation

First Image Marketing, Inc., a Florida Corporation



- Corporate Information -

Directors and Executive Officers  
**Marc Puleo, M.D.**  
Director and Chairman of the Board

**Menderes Akdag**  
Director, Chief Executive Officer  
and President of the Company

**Frank J. Formica**  
Independent Director  
Legal Consultant

**Robert C. Schweitzer**  
Independent Director  
Regional President for  
Northwest Savings Bank

**Ronald J. Korn**  
Independent Director  
President of Ronald Korn Consulting

**Gian M. Fulgoni**  
Independent Director  
Chairman of ComScore Networks, Inc.

**Bruce S. Rosenbloom, CPA**  
Chief Financial Officer and Treasurer  
of the Company

**Alison Berges**  
Corporate Secretary and  
General Counsel of the Company

Corporate Headquarters  
PetMed Express, Inc.  
1441 S.W. 29<sup>th</sup> Avenue  
Pompano Beach, Florida 33069

Independent Registered Public Accounting Firm  
Goldstein Golub Kessler LLP  
New York, New York

Transfer Agent  
Florida Atlantic Stock Transfer, Inc.  
Tamarac, Florida

Stock Exchange Listing  
Nasdaq National Market  
Trading symbol: PETS

Annual Meeting  
The Annual Meeting of Stockholders will be held at 1:00 p.m., Eastern Time,  
July 28, 2006.

Investor Relations  
PetMed Express, Inc. welcomes inquiries from stockholders and other  
interested investors. You may contact us by phone: (800) 738-6337 or  
(954) 979-5995 or by writing to the corporate headquarters address above.



**QUARTERLY  
STOCK  
PRICE RANGE**

| First Quarter      |         |
|--------------------|---------|
| <i>Fiscal 2006</i> |         |
| High               | \$ 8.21 |
| Low                | \$ 6.50 |
| <i>Fiscal 2005</i> |         |
| High               | \$12.29 |
| Low                | \$ 6.73 |

| Second Quarter     |          |
|--------------------|----------|
| <i>Fiscal 2006</i> |          |
| High               | \$ 11.64 |
| Low                | \$ 7.63  |
| <i>Fiscal 2005</i> |          |
| High               | \$ 8.10  |
| Low                | \$ 4.10  |

| Third Quarter      |          |
|--------------------|----------|
| <i>Fiscal 2006</i> |          |
| High               | \$ 15.52 |
| Low                | \$ 9.83  |
| <i>Fiscal 2005</i> |          |
| High               | \$ 7.61  |
| Low                | \$ 4.63  |

| Fourth Quarter     |          |
|--------------------|----------|
| <i>Fiscal 2006</i> |          |
| High               | \$ 19.99 |
| Low                | \$ 14.34 |
| <i>Fiscal 2005</i> |          |
| High               | \$ 8.55  |
| Low                | \$ 6.50  |

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## *- Our Mission -*

To deliver savings and convenience to our customers, while providing superior customer care and support.