SONOSITE INC
Form 10-Q
May 15, 2001

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[X] Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the quarterly period ended March 31, 2001

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 0-23791

SONOSITE, INC.
(Exact name of registrant as specified in its charter)

Washington	91-1405022
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

21919 - 30th Drive SE, Bothell, WA 98021-3904
(Address of Principal Executive Offices) (Zip Code)

(425) 951-1200
(Registrant's Telephone Number, Including Area Code)

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

Yes [X] No [ ]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, $0.01 par value	9,632,704
(Class)	(Outstanding as of May 10, 2001)

1

SonoSite, Inc.

Quarterly Report on Form 10-Q

For the Quarter Ended March 31, 2001

Table of Contents

2

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

SonoSite, Inc.
Condensed Balance Sheets
(unaudited)

Assets

(In thousands, except share data)	March 31, 2001	December 31, 2000
Current assets:		
Cash and cash equivalents	$ 4,709	$ 11,067
Short-term investment securities	14,722	18,218
Accounts receivable, less allowance for doubtful		

accounts of $723 for each period presented	9,094	7,303
Accrued interest receivable	286	330
Inventories	10,511	12,325
Prepaid expenses and other current assets	589	1,070
Total current assets	39,911	50,313
Property and equipment, net	5,770	5,980
Investment in affiliates	--	112
Receivable from affiliates	822	880
Other assets	654	739
Total assets	$ 47,157	$ 58,024

Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable	$ 1,717	$ 5,561
Accrued expenses	3,006	3,684
Current portion of long-term obligations	182	253
Deferred revenue	318	281
Total current liabilities	5,223	9,779
Deferred rent	166	121
Long-term obligations, less current portion	285	316
Total liabilities	5,674	10,216
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, $1.00 par value		
Authorized shares - 6,000,000		
Issued and outstanding shares - none	--	--
Common stock, $.01 par value:		
Authorized shares - 50,000,000		
Issued and outstanding shares:		
As of March 31, 2001 - 9,615,416		
As of December 31, 2000 - 9,551,596	96	96
Additional paid-in-capital	109,706	109,195
Accumulated deficit	(68,217)	(61,492)
Accumulated other comprehensive loss	(102)	9
Total shareholders' equity	41,483	47,808
Total liabilities and shareholders' equity	$ 47,157	$ 58,024

See accompanying notes to condensed financial statements.

SonoSite, Inc.
Condensed Statements of Operations
(unaudited)

(In thousands, except loss per share)	Quarters Ended March 31,	
	2001	2000
Sales	$ 8,163	$ 8,015
Cost of sales	4,866	4,653
Gross margin	3,297	3,362
Operating expenses:		
Research and development	3,555	2,477
Sales and marketing	5,267	3,608
General and administrative	1,395	1,130
Total operating expenses	10,217	7,215
Other income (loss):		
Interest income	388	719
Interest expense	(32)	(38)
Equity in losses of affiliates	(161)	(72)
Total other income	195	609
Net loss	$ (6,725)	$ (3,244)
Basic and diluted net loss per share	$ (0.70)	$ (0.35)
Weighted average common and potential common shares used in computing net loss per share	9,567	9,225

See accompanying notes to condensed financial statements.

4

SonoSite, Inc.
Condensed Statements of Cash Flows
(unaudited)

(In thousands)	Quarters E March 3
	2001
Operating activities:	
Net loss	$ (6,725)
Adjustments to reconcile net loss to net cash used in operating activities:	
Depreciation and amortization	595
Equity in loss of affiliates	161
Amortization of premium on investment securities and deferred compensation	--
Changes in operating assets and liabilities:	

Increase in accounts receivable	(1,791)
Decrease (Increase) in receivable from affiliates	58
Decrease (Increase) in interest receivable	44
Decrease (Increase) in inventories	1,814
Decrease (Increase) in prepaid expenses and other current assets	481
Decrease (Increase) in other assets	36
(Decrease) Increase in accounts payable	(3,844)
Decrease in accrued expenses	(678)
Increase (Decrease) in deferred rent	45
Increase (Decrease) in deferred revenue	37
Net cash used in operating activities	(9,767)
Investing activities:	
Purchase of investments	(2,574)
Proceeds from maturities of investments	5,959
Purchase of equipment	(386)
Proceeds on sale of equipment	1
Net cash provided by (used in) investing activities	3,000
Financing activities:	
Repayment of long-term obligations	(102)
Proceeds from sale of common stock, net of issuance costs	--
Exercise of stock options	511
Net cash provided by financing activities	409
Net change in cash	(6,358)
Cash and cash equivalents at beginning of period	11,067
Cash and cash equivalents at end of period	$ 4,709
Supplemental disclosure of cash flow information:	
Cash paid for interest	$ 42
Supplemental disclosure of non-cash investing and financing activities:	
Unrealized gain/(loss) on investment	$ (111)

See accompanying notes to condensed financial statements.

SonoSite, Inc.

Notes to Condensed Financial Statements
(unaudited)

Interim Financial Information

The information contained herein has been prepared in accordance with instructions for Form 10-Q and Article 10 of Regulation S-X. The information furnished reflects, in the opinion of SonoSite, Inc. management, all adjustments necessary (which are of a normal and recurring nature) for a fair presentation of the results for the interim period presented. The results of operations for the quarter ended March 31, 2001 are not necessarily indicative of our expected results for the entire year ending December 31, 2001 or for any other fiscal period. These financial statements do not include all disclosures required by generally accepted accounting principles. For a presentation including all disclosures required by generally accepted accounting principles, these financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2000, included in our Annual Report on Form 10-K. Certain amounts reported in previous years have been reclassified to conform to current year presentation.

Business Overview

SonoSite commenced operations as a division of ATL Ultrasound, Inc., or ATL. We were formed to develop the design and specifications for a highly portable ultrasound device and other highly portable ultrasound products for diagnostic imaging in a multitude of clinical and field settings. On April 6, 1998, we became an independent, publicly owned company through a tax-free distribution of one new share of our stock for every three shares of ATL stock held as of that date. ATL retained no ownership in SonoSite following the spin-off.

We finalized the development and began commercialization of our first products in 1999, recognizing our initial product sales revenue in September 1999. Continuing to develop and enhance our products in 2000, we introduced the SonoHeartTM system for cardiology and the high frequency SonoSite(R) 180 system, along with three new transducers. As of March 31, 2001, our products were comprised of two highly portable ultrasound systems, the SonoSite 180 and SonoHeart systems, and five transducers. Subsequent to March, we announced the release of our SonoSite 180PLUS and SonoHeart PLUS systems, both of which include M-mode, Pulsed Wave Doppler and Tissue Harmonics Imaging capabilities.

Financial Instruments

Cash equivalents
Cash equivalents consist of money market and highly liquid debt instruments with original or remaining maturities at purchase of three months or less.

Investment securities
Investment securities consist of high-grade corporate debt. While our intent is to hold our securities until maturity, we classified all securities as available-for-sale because the sale of such securities may be required prior to maturity to implement management strategies. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive loss until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis.

6

A decline in market value of any available-for-sale security below cost that is determined to be other than temporary results in a revaluation of its carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Interest income is recognized when earned.

Foreign currency translations and transactions
The United States dollar is considered to be the functional currency of the company and our subsidiary. Monetary assets and liabilities of our foreign subsidiary are remeasured into United States dollars from the local currency at rates in effect at period-end and non-monetary assets and liabilities are remeasured at historical rates. Revenues and expenses are remeasured at average rates during the period. Gains and losses arising from the remeasurement of local currency financial statements are included in non-operating income.

Accounts receivable
In the ordinary course of business, we grant credit to a broad customer base. Of the accounts receivable balance at March 31, 2001, 71% and 29% were receivable from international and domestic parties, prior to any provision for doubtful accounts, of which approximately $250,000 was classified as a long-term other asset. The same percentages as of December 31, 2000 were 51% and 49%.

During the first quarter of 2001, sales revenue was 56% international and 44% domestic. During the first quarter 2000, sales revenue was 79% international and 21% domestic.

The following table presents individual customers whose outstanding receivable balance as a percentage of total trade receivables and/or revenue as a percentage of total sales revenue exceeded 10%:

	Accounts Receivable		Sales Re
	As of		For the Quar
	March 31, 2001	December 31, 2000	March 31, 2001
Brazilian distributor		11%	
Japanese distributor	13%		15%
Middle Eastern distributor	16%		18%
United States distributor			
Totals	29%	11%	33%

Fair value of financial instruments
The carrying value of our financial instruments, including cash and cash equivalents, accounts receivable, certain long-term other assets and debt, approximates fair value. Cash and cash equivalents and accounts receivable approximate fair value due to their short-term nature. Long-term other assets and debt approximate fair value as interest rates on these notes approximate market.

Inventories
Inventories are stated at the lower of cost, on a first-in, first-out method, or market. Inventories consist of the following (in thousands):

	March 31, 2001	December 31, 2000
Raw material	$ 4,578	$ 4,172
Finished goods	5,933	8,153
Total	$10,511	$12,325

Property and equipment
Property and equipment are stated at historical cost, less accumulated depreciation and amortization. Maintenance and repair costs are expensed as incurred, with additions and improvements to property and equipment capitalized.

Depreciation and amortization are calculated using the straight-line basis over estimated useful lives as follows:

Asset	Estimated Useful Lives
Equipment, other than computer	5-7 years
Software	3 years
Computer equipment	3-5 years
Furniture and fixtures	5 years
Leasehold improvements	Lesser of estimated useful life or expected remaining lease term

The carrying value of long-lived assets is evaluated for impairment when events or changes in circumstances occur, which may indicate the carrying amount of the asset may not be recoverable. We evaluate the carrying value of the assets by comparing the estimated future cash flows generated from the use of the asset and its eventual disposition with the assets' reported net book value.

Investment in affiliates
Where we have investments in which we have the ability to exercise significant influence over operating and financial policies, these investments are accounted for under the equity method. Accordingly, our share in the net income or loss in these investments is included in other operating income or loss.

Concentration of credit risk
Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash equivalents, investments and accounts receivable.

Accumulated Other Comprehensive Loss

Other comprehensive losses consist entirely of net unrealized losses on investments.

The following presents the components of comprehensive loss for the quarter ending March 31 (in thousands):

	2001	2000
Net loss	$ (6,725)	$ (3,244)
Other comprehensive loss:		
Unrealized loss on investments	(111)	(109)
Comprehensive loss	$ (6,836)	$ (3,353)

Net Loss per Share

Basic and diluted net loss per share was computed by dividing the net loss by the weighted average shares outstanding exclusive of unvested restricted shares.

Outstanding options to purchase our shares and our unvested restricted shares were not included in the computations of diluted net loss per share because to do so would be antidilutive. As of March 31, 2001, our outstanding options and unvested restricted shares totaled 2,285,832 and 642. As of March 31, 2000, our outstanding options and unvested restricted shares totaled 2,111,460 and 11,931.

The following is a reconciliation of the numerator and denominator of the basic and diluted loss per share calculations:

(in thousands, except loss per share)

	March 31, 2001			March 200	
	Loss	Shares	LPS	Loss	Sha
Weighted average shares outstanding		9,568			9,
Weighted average unvested restricted stock		(1)			
Basic and diluted loss per share	$(6,725)	9,567	$(.70)	$(3,244)	9,

New Accounting Pronouncement

In June 1998, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards No. 133 (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities." SFAS 133 establishes accounting and reporting standards requiring that every derivative instrument, including certain derivative instruments embedded in other contracts, be recorded in the balance sheet as either an asset or liability measured at its fair value. The statement also requires that changes in the derivative instrument's fair value be recognized in earnings unless specific hedge accounting criteria are met. This statement became effective for us beginning January 1, 2001. Our adoption of the standard did not have a material effect on our financial results.

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

Certain statements in this Quarterly Report on Form 10-Q are "forward-looking statements." Forward-looking statements are based on the opinions and estimates of our management at the time the statements are made and are subject to risks and uncertainties that could cause our actual results to differ materially from those expected or implied by the forward-looking statements. The words "believe," "expect," "intend," "anticipate" and similar expressions are intended to identify forward-looking statements, but their absence does not necessarily mean that the statement is not forward-looking. These statements are not guaranties of future performance and are subject to known and unknown risks and uncertainties and are based upon potentially inaccurate assumptions. Factors that could affect SonoSite's actual results include those described under the heading "Important Factors That May Affect Our Business, Our Results of Operations and Our Stock Price" in this Form 10-Q and in our filings from time to time with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended December 31, 2000. We caution readers not to place undue reliance upon these forward-looking statements that speak only as to the date of this report. We undertake no obligation to publicly revise any forward-looking statements to reflect new information, events or circumstances after the date of this Form 10-Q or to reflect the occurrence of unanticipated events.

Overview

SonoSite commenced operations as a division of ATL. We were formed to develop the design and specifications for a highly portable ultrasound device and other highly portable ultrasound products for diagnostic imaging in a multitude of clinical and field settings. On April 6, 1998, we became an independent, publicly owned company through a tax-free distribution of one new share of our stock for every three shares of ATL stock held as of that date. ATL retained no ownership in SonoSite following the spin-off.

We finalized the development and began commercialization of our first products in 1999 and recognized our initial product sales revenue in September 1999. Continuing to develop and enhance our products in 2000, we introduced the SonoHeart system for cardiology and the high frequency SonoSite 180 system, along with three new transducers. As of March 31, 2001, our products were comprised of two highly portable ultrasound systems, the SonoSite 180 and SonoHeart systems, and five transducers. Subsequent to March 31 2001, we introduced the SonoSite 180PLUS and SonoHeart PLUS systems. The PLUS systems include M-mode and provide feature options of Pulsed Wave (PW) Doppler and Tissue Harmonics Imaging.

9

Initially, we sold our products primarily through medical product distributors worldwide. In 2000, we developed and introduced a contract direct sales force in the United States market to supplement and eventually replace our distributors in the United States. Recognizing the value of real-world experience, we utilized sonographers, some of whom had no selling experience, and trained them in selling our systems. As the year progressed, we saw significant increases in revenue generated by this direct sales group in the United States. As a result, we hired these sonographers onto our direct sales team in early 2001. Further, we nearly doubled the number of sales consultants domestically by adding proven, professional sales people, bringing our total to 40 by the end of March as we continue to penetrate the key geographical and specialty segments that we identified in 2000. We intend to continue to add sales consultants in the second quarter and currently anticipate having approximately 50 sales consultants in the United States by the end of the quarter.

Internationally, we continue to address other larger potential markets in the world through our relationship with Olympus in Japan, our joint venture in China and dedicated distributors in other traditionally large ultrasound markets. Through these relationships, we anticipate that we can effectively address large potential markets. In the first quarter of 2001, after seeing the success in the United States, we established a subsidiary in the United Kingdom, SonoSite, Ltd., which sells directly in the United Kingdom. We anticipate expanding our direct selling efforts into Germany and France in the future.

In the future, our prospects and ability to grow a profitable business will depend on our ability to effectively market and sell our products to a variety of customers, both in terms of geography and medical segment. We identified those markets where we believe that our products will generate sales and that we possess a significant opportunity to have a positive medical impact. These markets include obstetrics and gynecology, emergency medicine, radiology and surgery. In addition, we believe that our products can be successfully marketed and sold to address many other medical applications, of which many currently do not use ultrasound.

Since operations began, we have incurred losses. We expect to continue to incur operating losses unless and until our product sales generate sufficient revenue to fund our continuing operations. We may be unable to generate sufficient revenue to fund our operations in future periods.

Results of Operations

Sales

Sales increased to $8.2 million for the quarter ended March 31, 2001 compared to $8.0 million for the quarter ended March 31, 2000, an increase of $200,000. Coinciding with our increase in direct sales, current quarter sales represent a growing number of end customer sales, as opposed to the comparable prior year quarter that primarily consisted of orders to meet initial distributor demand. Product revenues are generally recognized at the time of shipment.

We anticipate that sales revenue will increase in 2001 as compared to prior years due to our expanded direct selling efforts, new product developments, new corporate customer agreements and overall expansion of general market awareness of the company and our products. As of March 31, 2001, our products included two platforms, the SonoSite 180 and SonoHeart, which, when used in conjunction with one of our five transducers, may be used in a variety of applications. Our transducers include a curved array transducer, the C60, for abdominal imaging, an intra-cavital transducer, the ICT, for transvaginal and intra-cavital imaging, a microconvex transducer, the C15, for cardiac imaging, a linear array transducer, the L38, for use in radiology, emergency medicine and vascular imaging and a neonatal transducer, the C11, for pediatric applications. Additionally, in April 2001, we released our PLUS systems, which offer M-mode, Pulsed Wave Doppler and Tissue Harmonics Imaging. We anticipate that product revenues in the second quarter will increase over the first quarter.

Gross margin on sales revenue

The gross margin on sales revenue for the quarters ended March 31, 2001 and 2000 was 40% and 42%. The decrease in gross margin is due to lower production line utilization than anticipated when we began manufacturing our product in-house. Prior to October 2000, third parties performed all of our manufacturing. We anticipate that the gross margin on our product sales will increase in 2001 due primarily to our increasing percentage of direct and domestic sales compared to distributor sales, which include a standard discount. Additionally, with the transfer of

manufacturing in-house, we anticipate product costs will decrease over 2001 as prodcution volume increases and production line utilization increases.

Research and development expenses

Research and development expenses for the quarters ended March 31, 2001 and 2000 were $3.6 million and $2.5 million. The increase in research and development expenses by $1.1 million was primarily the result of increased activities surrounding the design, tooling and testing of the SonoSite 180PLUS and SonoHeart PLUS systems, which were released in April 2001. We anticipate that spending levels in research and development will decrease in the near term.

Sales and marketing expenses

Sales and marketing expenses for the quarters ended March 31, 2001 and 2000 were $5.3 million and $3.6 million. The increase of $1.7 million in 2001 compared to 2000 is primarily due to increases in personnel and personnel-related expenses, our direct sales force and related commissions and increases in advertising and promotion activity to support both our new and existing products within our core markets.

We continue to recognize the need to support our existing products and expect marketing and selling costs to increase in 2001 as we increase the size of our direct selling force and support our new PLUS system platform. This increase includes expanding our direct selling efforts to certain European markets.

General and administrative expenses

General and administrative expenses for the quarters ended March 31, 2001 and 2000 were $1.4 million and $1.1 million. The increase of $300,000 in 2001 compared to 2000 was primarily the result of added personnel in our general and administrative functions to support our growth.

Other income

Other income for the quarters ended March 31, 2001 and 2000 was $195,000 and $609,000. In 2001, other income consisted of $388,000 of interest income, which was partially offset by $32,000 of interest expense and $161,000 of losses from equity method investees. In 2000, other income consisted of $719,000 of interest income, which was partially offset by $38,000 of interest expense and $72,000 of losses from equity method investees. The decrease in interest income between 2001 and 2000 of approximately $331,000 is due to our lower average investment balance. The increase in equity in losses of affiliates was primarily the result of operating losses by our equity investee.

Liquidity and Capital Resources

In the first quarter of 2001, our cash and cash equivalents balance decreased by $6.4 million. This decrease was the result of $9.8 million used in operating activities, which is offset by $3.0 million provided by investing activities. The operating cash uses, consisting of our net loss of $6.7 million, usages in our accounts receivable of $1.8 million and decreases in our accounts payable of $3.8 million and accrued expenses of $678,000, were partially offset by reductions in inventory of $1.8 million, prepaid expenses and other current assets of $481,000 and depreciation expense of $595,000. Cash provided by investing activities represented the net of proceeds from investment maturities of $6.0 million and purchases of investments of $2.6 million.

During the year ended December 31, 2000, our primary source of operating capital was obtained from our sales revenue and cash on hand that was obtained from public and private capital financing in prior years. In April 1999, we raised net proceeds of $35.4 million through the sale of 2,990,000 shares of our common stock. In November 1999, we raised additional net proceeds of $29.3 million through the sale of 1,250,000 shares of our common stock. We also received $30.0 million from ATL in connection with our spin-off, of which $18.0 million was received in 1998 and $12.0 million in 1999.

We expect our cash requirements to continue in future periods as we continue to fund losses until we can generate sufficient revenues to meet our operating expenses. However, we expect our cash requirements to decrease in 2001 compared to 2000 due to an increase in sales revenue. We expect operating expenses to increase as we continue to

fund our manufacturing and research and development activities, increase our direct selling efforts and targeted marketing plans, enhance our educational offerings and provide adequate administrative support for these areas. We believe that our existing cash will be sufficient to fund our operations through 2001. However, it is difficult to accurately predict the amount of cash that we may require during 2001. Actual cash needs will depend in part upon factors beyond our control, such as lower than anticipated revenues, technical obstacles, market acceptance of our products, disruption in manufacturing or the supply of raw materials, economic circumstances and cost overruns. If additional capital is required, we may not be able to obtain adequate financing on a timely basis, on terms acceptable to us, or at all.

Important Factors That May Affect Our Business, Our Results of Operations and Our Stock Price

We have a limited history as a stand-alone company.

We commenced operations as a stand-alone company in April 1998. Prior to that, we operated as a business unit of ATL. We shipped our first products in September of 1999. Accordingly, we have a limited operating and sales history. Additionally, we only recently brought manufacturing of our products in-house. As a result, our prospects for success are difficult to determine. When evaluating whether to invest in our common stock, you should consider our business and prospects in light of the risks and uncertainties encountered by new technology and manufacturing companies.

There are many reasons why we may be unsuccessful in implementing our strategy, including:

- any inability to manufacture our products with the quality and quantity necessary to achieve profitability;
- our dependence on the market acceptance of a new platform for ultrasound imaging procedures;
- our inability to achieve market acceptance of our products for any other reason;
- our reliance on third-party suppliers of material components;
- any failure in our newly developed and implemented in-house manufacturing operations;
- our need to maintain and expand sales channels;
- our need to obtain governmental approvals in key foreign markets;
- any loss of key personnel;
- any inability to respond effectively to competitive pressures;
- any inability to manage rapid growth and expanding operations; and
- any failure to comply with governmental regulations.

We have a history of losses, we expect future losses and we may never be profitable.

We incurred net losses in each quarter since we started operations and have a limited history of product sales. As of March 31, 2001, we had an accumulated deficit of approximately $68.2 million, including approximately $10.6 million that was accumulated prior to our commencing operations as a separate company in April 1998. We expect to incur substantial additional expenses in the future as we continue to conduct research and development efforts on newer generation products and increase sales and marketing efforts. We will need to generate significant additional revenues in the future before we will be able to achieve and maintain profitability. Our business strategies may not be successful and we may not be profitable in any future period. If we do become profitable, we cannot be certain that we can sustain or increase profitability on a quarterly or annual basis.

Demand for our products is unknown.

Our products represent a new platform for ultrasound imaging procedures and we have sold our products in limited quantities. The market for hand-carried, high-performance ultrasound devices is new and largely undeveloped. We do not know the rate at which physicians or other healthcare providers will adopt our products or the rate at which

they will purchase them in the future. Acceptance of our products by physicians, including physicians who do not currently use ultrasound, is essential to our success and may require us to overcome resistance to a new platform for ultrasound imaging.

Current users of ultrasound may resist change to established industry practices and discourage widespread new users and uses.

Currently, patients requiring an ultrasound examination are generally referred to a centralized testing location. Radiologists and other specialized providers of ultrasound at these locations may have an incentive to discourage market acceptance of our products in order to maintain these referrals.

Physicians and other healthcare providers will not purchase our products unless they determine that they are preferable to other means of obtaining an ultrasound examination and that the benefits to the patient and physician outweigh the costs of purchasing our products. This determination will depend on our products' image quality, cost-effectiveness, ease of use, reliability and portability. Furthermore, acceptance of our products by physicians and other healthcare providers may be more difficult if they are unable to obtain adequate reimbursement from third-party payers for tests performed using our products. In addition, while we priced our products to be competitive in the marketplace for lower-end ultrasound machines, our pricing policies could limit market acceptance compared to competing products or alternative testing methods.

Customer training and education may not be available, sufficient or accepted by new users of ultrasound.

Use of our products will require training for physicians who currently do not use ultrasound-imaging instruments. The time required to complete such training might be substantial and could result in a delay or decrease in market acceptance. We anticipate new users of ultrasound to provide us with future revenue streams. If new users are not able or willing to be trained due to time constraints or availability of courses, our ability to enter new markets will be adversely impacted.

We only recently assumed some of the manufacture and assembly of our products.

In the second half of 2000, we began to transition the manufacturing operations from ATL to our own facility under the control of our employees. This transition was completed in December 2000. In order to make this transition, we built a series of manufacturing lines and developed our own manufacturing processes and procedures. The production of our products may be interrupted, resulting in harm to our business, for any number of reasons, including line shutdowns, product procurement issues, procedural issues, rework, quality control issues or negative yield issues. Additionally, we may be unable to comply with regulations applicable to manufacturers of ultrasound devices. We may be unable to manufacture our products at a cost or in quantities necessary to achieve or maintain profitability. Any of these risks may prevent us from meeting production schedules and quality requirements.

If our vendors fail to supply us with the highly specialized parts and other components we need for our products, we will be unable to effectively ship our products.

We depend on vendors to supply highly specialized parts, such as custom-designed integrated circuits, cable assemblies and transducer components. These vendors may experience difficulty in manufacturing these parts or in meeting our high quality standards. In addition, these parts may have long order lead-times, which restrict our ability to respond quickly to changing market conditions. If we are required to switch vendors, the manufacture and delivery of our products could be interrupted for an extended period. We also rely on third-party vendors to supply essential parts and components that are in high demand in other industries such as electronics manufacturing and telecommunications equipment manufacturing. Our ability to manufacture and deliver products in a timely manner could be harmed if these vendors fail to maintain an adequate supply of these components.

We depend on single-source vendors for some of our components that may be difficult and costly to replace.

We depend on single-source vendors for some key components for our products, including custom-designed integrated circuits, image displays, batteries, capacitors, cables and transformers. There are relatively few alternative sources of supply for some of these components. While these vendors have generally produced our components with acceptable quality, quantity and cost in the past, they have experienced periodic problems that have caused us delays

in production. To date, these problems have not been material. These suppliers may be unable to meet our future demands or may experience quality and specification problems, which might cause us to experience delays, incur additional costs and possibly miss customer deliveries. Establishing additional or replacement suppliers for these components may take a substantial amount of time. If we have to switch to a replacement vendor, the manufacture and delivery of our products could be interrupted.

Our future success could be impaired if the perception of our products is based on any early performance problems.

We will not succeed unless the marketplace is confident that we can provide high-quality products and deliver them in a timely manner. We have a limited history of product sales. If these early product shipments or new product releases fail to perform as expected or if they are perceived as being difficult to use or causing discomfort to patients, the public image of our products may be impaired. Public perception may also be impaired if we fail to deliver our products in a timely manner due to difficulties with our suppliers and vendors or due to our inability to efficiently manufacture, assemble and service our products in-house. A tarnished reputation could result in the failure of our products to gain market acceptance even after any quality or delivery problems are resolved.

We may be unable to manage our growth, which could strain our resources and impair our ability to deliver our products.

We expect significant growth in all areas of operations as we develop and market our products. We will need to add personnel and expand our capabilities, which may strain our existing management, operational, financial and other resources. To compete effectively and manage future growth, we must

- accurately forecast demand for our products;
- effectively and efficiently manufacture and service our products;
- manage our order fulfillment process;
- manage our inventory;
- train, manage and motivate a growing employee base;
- mitigate our receivables risk; and
- improve existing operational, financial and management information systems.

We may be unable to complete necessary improvements to our systems, procedures and controls to support our future operations in a timely manner. In addition, we may be unable to attract or retain required personnel and our management may be unable to develop the additional expertise required to manage any future growth.

Our quarterly operating results are uncertain and may fluctuate significantly, which could impair the value of your investment.

Our future operating results will depend on numerous factors, many of which we do not control. Changes in any or all of these factors could cause our operating results to fluctuate and increase the volatility of our stock. Some of these factors are

- demand for our products;
- product and price competition;
- global economic conditions;
- changes in the component costs;
- success of our direct sales and distribution channels;
- successful development and commercialization of new and enhanced products;

- timing of new product introductions and product enhancements by us or our competitors; and
- timing and magnitude of our expenditures.

In addition, we manufacture our products and determine product mix based on forecasts of sales in future periods. Our forecast in any particular period may prove inaccurate, which could cause fluctuations in our manufacturing costs and our operating results. Our future operating results could fall below the expectations of securities analysts or investors and reduce the market price of our stock. We believe that there may be some fluctuations caused by year-end budgetary pressures on our customers, customer buying patterns and the efforts of our direct sales and distribution network to meet or exceed annual sales quotas. These factors make it difficult to forecast our revenues and operating results.

The market for ultrasound imaging products is highly competitive and we may be unable to compete.

The existing market for ultrasound imaging products is well established and intensely competitive. In addition, we are seeking to develop new markets for our hand-carried ultrasound imaging products. In response, we expect competition to increase as potential and existing competitors begin to enter these new markets or modify their existing products to compete directly with ours. Our primary competitors have

- better name recognition;
- significantly greater financial resources; and
- existing relationships with some of our potential customers.

Our competitors may be able to use their existing relationships to discourage customers from purchasing our products. In addition, our competitors may be able to devote greater resources to the development, promotion and sale of new or existing products, thereby allowing them to respond more quickly to new or emerging technologies and changes in customer requirements.

We rely on an indirect sales and distribution network to sell our products internationally.

Initially, we established an indirect sales and distribution network internationally to sell our products. Our future revenue growth will depend in part on our success in maintaining and expanding these indirect sales and distribution channels. While we intend to establish direct selling forces in targeted European markets, we currently depend on these distributors to help promote market acceptance and demand for our products. Many of our foreign distributors are in the business of distributing other, sometimes competing, medical products. As a result, our products may not receive the resources and support required within these countries to meet our sales objectives. Our success is tied closely to the success of these distributors and their ability to market and sell our products. Inherent in these international markets are certain risks, including:

- the costs of localizing products for foreign markets;
- longer receivables collection periods and greater difficulty in receivables collection, as compared to those experienced in the United States;
- reduced protection for intellectual property rights in some countries;
- fluctuations in the value of the United States dollar relative to other currencies; and
- delays or failures in obtaining necessary regulatory approvals.

If the distribution channels are negatively impacted by local economies, unforeseen management issues, legal issues, or any number of adverse circumstances, our distributors' willingness to promote and sell our products may decrease. We intend to develop our own direct sales network in targeted international markets and may elect to expand or replace our distributors in other international markets. We cannot assure you that we will be able to develop our own sales force in foreign markets, if at all, or change distributors in these markets effectively or in a cost efficient manner.

Our direct selling force is new, and efforts to maintain and expand a qualified sales force at a reasonable cost may not be successful.

We began direct sales of our products in the United States in February 2000 with a contract sales force comprised of sonographers with little direct sales experience. We nearly doubled the size of our direct sales force in the United States and began direct selling in Western Europe in the first quarter of 2001. This expansion requires extensive training and management as well as increasing administrative activities. We may not be able to train qualified sales personnel to meet our objectives. Further, they may not be ultimately successful. In addition, costs associated with maintaining and growing a sales force are difficult to control and manage and consequently may adversely affect our results.

We have limited marketing experience.

As we market our products as a new platform within the established ultrasound market and promote our products for new users, marketing will be critical to generate awareness and consequently product sales. To be successful, our marketing efforts need to identify the potential markets and also identify the methods to reach and develop these markets. We must also be successful in generating sales leads and processing these leads effectively to generate product sales. We may not be successful in creating brand awareness sufficient to positively impact product sales. In addition, we may not be successful in our marketing efforts throughout the world. Our marketing efforts also must be successful in removing barriers in the marketplace, including the efforts of our competitors to discredit us, the availability and ease of educating users in the use of our product and the resistance that may be shown by existing ultrasound users.

If we do not retain key employees and attract additional highly skilled employees, we will not be successful.

Our future performance will depend largely on the efforts and abilities of our key technical, marketing, selling and managerial personnel and our ability to retain them. We may be unable to attract qualified, highly skilled personnel into key positions, in particular our sales representatives. Our success depends on our ability to attract and retain additional key personnel in the future. While we do not have any employment agreements with any of our employees, we do have change in control agreements with certain of our executives, which prevent them from working for a competitor within a designated period of time after leaving us. Nevertheless, the loss of any of our key employees could harm our business, particularly the loss of any of our key engineering or sales personnel. We do not maintain key-person insurance on any of our employees.

We may be unable to adequately protect our intellectual property rights, which could harm our business.

Our success and ability to compete depend on our licensed and internally developed technology. We seek to protect our proprietary technology through a combination of patent, copyright, trade secret and trademark laws. We also enter into confidentiality or license agreements with our employees, consultants and corporate partners, and generally control access to, and the distribution of, our product designs, documentation and other proprietary information, as well as the designs, documentation and other information that we license from others. Despite our efforts to protect these proprietary rights, unauthorized parties may copy, develop independently or otherwise obtain and use our products or technology.

We cannot be sure that our pending patent applications will result in issued patents. In addition, our issued patents or pending applications may be challenged or circumvented by our competitors. Policing unauthorized use of our intellectual property will be difficult and we cannot be certain that we will be able to prevent misappropriation of our technology, particularly in countries where the laws may not protect our proprietary rights as fully as in the United States. In addition, the cost of policing or defending our patent, copyright or trademarks may be prohibitive.

Our products may infringe on the intellectual property rights of others, which could subject us to significant liability.

Many of our competitors in the ultrasound imaging business hold issued patents and have filed, or may file, patent applications. Our competitors may claim that our technology or products infringe upon the technology covered by these patents or patent applications. Any such claims, with or without merit, could

16

- be time-consuming to defend;
- result in costly litigation;
- divert management's attention and resources;
- cause product shipment delays;
- require us to enter into royalty or licensing agreements;
- prevent us from manufacturing or selling some or all of our products; or
- result in our liability to one or more of these competitors.

If a third party makes a successful claim of patent infringement against us, we may be unable to license the infringed or similar technology on acceptable terms, if at all.

Our products may become obsolete.

Our competitors may develop and market ultrasound products that render our products obsolete or noncompetitive. In addition, although diagnostic ultrasound imaging products may have price and performance advantages over competing medical imaging equipment, such as computed tomography and magnetic resonance imaging, any price or performance advantages may not continue. Our products could become obsolete or unmarketable if other products utilizing new technologies are introduced or new industry standards emerge. As a result, the life cycles of our products are difficult to estimate. To be successful, we will need to continually enhance our products and to design, develop and market new products that successfully respond to any competitive developments. In addition, because our products are based on a single platform, we may be more vulnerable to adverse events affecting the healthcare industry generally and the medical ultrasound market specifically, than we would be if we offered products based on more than one platform.

We may incur tax liability in connection with our spin-off from ATL

Our spin-off was treated by ATL as a tax-free spin-off under Section 355 of the

Internal Revenue Code of 1986. However, if ATL were to recognize taxable gain from the spin-off, the Internal Revenue Service could impose that liability on any member of the ATL consolidated group as constituted prior to the spin-off, including us. ATL agreed to cover 85% of any such liability, unless the tax is imposed due to our actions solely or by ATL solely; in which case, we have agreed with ATL that the party who is solely at fault shall bear all of the tax liability. We cannot guarantee that ATL would indemnify us or agree that it caused the liability to be imposed. If we were required to pay all or a portion of any taxes related to the spin-off, our business would be adversely affected.

Governmental regulation of our business could prevent us from introducing new products in a timely manner.

All of our planned products and our manufacturing activities and the manufacturing activities of our third-party medical device manufacturers are subject to extensive regulation by a number of governmental agencies, including the FDA and comparable international agencies. Our third-party manufacturers and we are or will be required to

- undergo rigorous inspections by domestic and international agencies;
- obtain the prior approval of these agencies before we can market and sell our products; and
- satisfy content requirements for all of our sales and promotional materials.

Compliance with the regulations of these agencies may delay or prevent us from introducing new or improved products. We may be subject to sanctions, including the temporary or permanent suspension of operations, product recalls and marketing restrictions, if we fail to comply with the laws and regulations pertaining to our business. Our third-party medical device manufacturers may also be subject to the same sanctions and, as a result, may be unable to supply components required to manufacture our products.

We may face product liability and warranty claims, which could result in significant costs.

The sale and support of our products entail the risk of product liability, malpractice or warranty claims, such as those based on claims that the failure of one of our products, or our failure to properly train the users of our products, resulted in a misdiagnosis. The medical instrument industry in general has been subject to significant medical malpractice and product liability litigation. We may incur significant liability in the event of such litigation. Although we maintain product liability and incidental medical malpractice insurance, we cannot be sure that this coverage is adequate or that it will continue to be available on acceptable terms, if at all.

We also may face warranty exposure, which could adversely affect our operating results. Our products generally carry a one-year warranty against defects in materials and workmanship. We will be responsible for all claims, actions, damages, liens, liabilities, costs and expenses for all product recalls, returns and defects attributable to manufacturing. We established reserves for the liability associated with product warranties. However, any unforeseen warranty exposure could harm our operating results.

We may require additional funding to satisfy our future capital expenditure needs and our prospects of obtaining such funding are uncertain.

Our future revenues may not be sufficient to support the expenses of our operations and the expansion of our business. We may therefore need additional equity or debt capital to finance our operations as we develop our products and expand our sales. To date, our capital requirements have been met primarily by the sale of equity, sales revenue and contributions by ATL in connection with our spin-off. ATL's funding obligations have been met. As such, if we need additional financing, we would need to explore other sources of financing, including public equity or debt offerings, private placements of equity or debt and collaborative or other arrangements with corporate partners. Financing may not be available when needed or may not be available on acceptable terms. If we are unable to obtain financing, we may be required to delay, reduce or eliminate some or all of our research and development and sales and marketing efforts.

Our stock price has been and is likely to continue to be volatile.

The market price for our common stock and for securities of medical technology companies generally has been volatile in the past and is likely to continue to be volatile in the future. If you decide to purchase our shares, you may not be able to resell them at or above the price you paid due to a number of factors, including:

- actual or anticipated variations in quarterly operating results;
- the loss of significant orders;
- changes in earnings estimates by analysts;
- announcements of technological innovations or new products by our competitors;
- changes in the structure of the healthcare financing and payment systems;
- general conditions in the medical industry or global economy; and
- significant sales of our common stock by one or more of our principal shareholders.

Our restated articles of incorporation, our bylaws, Washington law and some of our agreements contain provisions that could discourage a takeover that may be beneficial to shareholders.

There are provisions in our restated articles of incorporation, our bylaws and Washington law that make it more difficult for a third party to obtain control of us, even if doing so would be beneficial to our shareholders. Additionally, our acquisition may be made more difficult or expensive by the following:

- a provision in our license agreement with ATL requiring a significant cash payment to ATL upon a change in control of SonoSite;
- a shareholder rights agreement; and

- acceleration provisions in benefit plans and change-in-control agreements with our employees.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to market risk relating to changes in interest rates, which could adversely affect the value of our investments in marketable securities or increase interest expense on outstanding obligations.

As of March 31, 2001, our portfolio consisted of $14.7 million of interest bearing securities with maturities of less than one year. Our intent is to hold these securities until maturity, but have classified them as available-for-sale in the event of liquidation or unanticipated cash needs. The interest bearing securities are subject to interest rate risk and will fall in value if market interest rates increase. We believe that the impact on the fair market value of our securities and related earnings for the remainder of 2001 from a hypothetical 10% increase in market interest rates would not have a material impact on either the investment portfolio or our obligations.

We distribute much of our product internationally through international distributors. Although virtually all transactions currently are transacted using United States dollars, economic and political risk exist within these international markets, which we cannot control. In addition, we have an affiliate that maintains certain accounts in a foreign currency. If the United States dollar were to uniformly increase in strength by 10% in 2001 relative to the currency of our affiliate, we believe the impact on our financial results would not be significant.

Part II: OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

a) Exhibits

Exhibit No.	Description
3.1*	Restated Articles of Incorporation of the Company
3.2**	Certificate of Designation of Series A Participating Cumulative Preferred Stock
3.3	Amended and Restated Bylaws of the Company
4.1*	Rights Agreement between First Chicago Trust Company and the Company, dated April 6, 1998
4.2***	Form of Purchase Agreement
10.3	Amended 1998 Nonofficer Employee Stock Option Plan

----

* Incorporated by reference to the designated exhibit included in the Company's Registration statement on Form S-1 (Registration No. 333-71457).

** Incorporated by reference to the designated exhibit included in the Company's report on Form 10 (SEC File No. 000-23791).

*** Incorporated by reference to the designated exhibit included in the Company's Registration Statement on Form S-3 (Registration No. 333-91083).

b) Reports on Form 8-K

No reports were filed on form 8-K during the quarter ended March 31, 2001.

SIGNATURE

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

SONOSITE, INC.
(Registrant)

Dated: May 14, 2001

By: /s/ MICHAEL J. SCHUH
Michael J. Schuh
Vice President-Finance,
Chief Financial Officer
and Secretary
(Authorized Officer and Principal
Financial Officer)

20

INDEX TO EXHIBITS

Exhibit No.	Description
3.1*	Restated Articles of Incorporation of the Company
3.2**	Certificate of Designation of Series A Participating Cumulative Preferred Stock
3.3	Amended and Restated Bylaws of the Company
4.1*	Rights Agreement between First Chicago Trust Company and the Company, dated April 6, 1998
4.2***	Form of Purchase Agreement
10.3	1998 Nonofficer Employee Stock Option Plan, as amended and restated

----

* Incorporated by reference to the designated exhibit included in the Company's Registration statement on Form S-1 (Registration No. 333-71457).

** Incorporated by reference to the designated exhibit included in the Company's report on Form 10 (SEC File No. 000-23791).

*** Incorporated by reference to the designated exhibit included in the Company's Registration Statement on Form S-3 (Registration No. 333-91083).