SONOSITE INC
Form 10-Q
November 10, 2008

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UNITED STATES

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 September 30, 2008

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the transition period from to ________ to ________

Commission file number 0-23791

SONOSITE, INC.

(Exact name of registrant as specified in its charter)

Washington **(State or Other Jurisdiction of Incorporation or Organization)**	**91-1405022** **(I.R.S. Employer Identification Number)**
21919 30th Drive SE, Bothell, WA **(Address of Principal Executive Offices)**	**98021-3904** **(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 by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer [ ] Accelerated filer [X] Non-accelerated filer [ ] Smaller reporting company [ ]

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

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 **(Class)**	**17,049,713** **(Outstanding as of November 3, 2008)**

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SonoSite, Inc.

Quarterly Report on Form 10-Q
For the Quarter Ended September 30, 2008

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

SonoSite, Inc.
Condensed Consolidated Balance Sheets
(unaudited)

(In thousands, except share data) **Assets**	**September 30, 2008**	**December 31, 2007**
Current assets:		
Cash and cash equivalents	$ 271,697	$ 188,701
Short-term investment securities	57,430	119,873

Accounts receivable, less allowances of $1,747 and $957	57,122	60,954
Inventories	29,354	29,740
Deferred income taxes, current	8,141	13,138
Prepaid expenses and other current assets	10,641	7,759
Total current assets	434,385	420,165
Property and equipment, net	9,344	10,133
Investment securities	1,340	1,257
Deferred income taxes	14,657	12,959
Goodwill and intangible assets, net	16,745	16,346
Other assets	11,468	9,521
Total assets	$ 487,939	$ 470,381
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 8,907	$ 8,868
Accrued expenses	21,925	24,431
Deferred revenue, current	2,962	3,502
Deferred tax liability, current	115	115
Total current liabilities	33,909	36,916
Long-term debt	225,000	225,000
Deferred tax liability	4,645	4,528
Other non-current liabilities	13,000	11,075
Total liabilities	276,554	277,519
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 September 30, 2008--16,981,420	170	
As of December 31, 2007--16,746,017		167
Additional paid-in-capital	246,442	236,158
Accumulated deficit	(36,398)	(44,893)
Accumulated other comprehensive income	1,171	1,430
Total shareholders' equity	211,385	192,862
Total liabilities and shareholders' equity	$ 487,939	$ 470,381

See accompanying notes to condensed consolidated financial statements.

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SonoSite, Inc.
Condensed Consolidated Statements of Income
(unaudited)

(In thousands, except net income per share)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenue	$ 61,633	$ 50,041	$ 173,362	$ 140,233
Cost of revenue	18,562	15,292	50,962	42,818
Gross margin	43,071	34,749	122,400	97,415
Operating expenses:				
Research and development	7,440	6,984	20,574	19,638
Sales, general and administrative	28,254	28,105	86,712	78,895
Licensing income and litigation settlement	(2,643)	--	(2,643)	--
Total operating expenses	33,051	35,089	104,643	98,533
Other income (loss)				
Interest income	2,188	3,568	7,142	5,825
Interest expense	(2,373)	(2,144)	(7,108)	(2,146)
Other	(1,516)	1,045	(2,842)	1,364
Total other income (loss), net	(1,701)	2,469	(2,808)	5,043
Income before income taxes	8,319	2,129	14,949	3,925
Income tax provision	3,593	642	6,454	1,294
Net income	$ 4,726	$ 1,487	$ 8,495	$ 2,631
Net income per share:				
Basic	$ 0.28	$ 0.09	$ 0.50	$ 0.16
Diluted	$ 0.27	$ 0.09	$ 0.49	$ 0.15
Weighted average common and potential common shares outstanding:				
Basic	16,927	16,657	16,858	16,586
Diluted	17,592	17,188	17,488	17,101

See accompanying notes to condensed consolidated financial statements.

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

(In thousands)	Nine Months Ended September 30,	
	2008	2007

Operating activities:		
Net income	$ 8,495	$ 2,631
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,086	3,157
Stock-based compensation	5,209	5,566
Deferred income tax provision (benefit)	5,068	882
Amortization of net discounts on investment securities	(443)	(3,653)
Amortization of debt issuance costs	798	264
Accretion of contingent purchase consideration	675	119
Excess tax benefit from exercise of stock based awards	(961)	(477)
Non-cash gain on litigation settlement	(643)	--
Investment other-than-temporary impairment	225	--
Changes in operating assets and liabilities:		
Accounts receivable	2,513	5,362
Inventories	63	(4,961)
Prepaid expenses and other assets	(4,836)	(2,434)
Accounts payable	64	2,368
Accrued expenses	(591)	4,393
Deferred liabilities	(724)	268
Net cash provided by operating activities	17,998	13,485
Investing activities:		
Purchases of investment securities	(182,608)	(659,748)
Proceeds from sales/maturities of investment securities	244,976	570,592
Purchases of property and equipment	(2,198)	(2,762)
Acquisition of LumenVu	--	(3,498)
Earn-out consideration associated with SonoMetric acquisition	(921)	(654)
Net cash provided by (used in) investing activities	59,249	(96,070)
Financing activities:		
Excess tax benefit from exercise of stock based awards	961	477
Proceeds from exercise of stock based awards	3,526	4,040
Proceeds from the issuance of convertible senior notes	--	217,606
Purchase of call options	--	(28,612)
Proceeds from sale of warrants	--	19,546
Net cash provided by financing activities	4,487	213,057
Effect of exchange rate changes on cash and cash equivalents	1,262	(1,662)
Net change in cash and cash equivalents	82,996	128,810
Cash and cash equivalents at beginning of period	188,701	45,673
Cash and cash equivalents at end of period	$ 271,697	$ 174,483
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 2,048	$ 729
Cash paid for interest	$ 8,414	$ --

See accompanying notes to condensed consolidated financial statements.

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SonoSite, Inc.
Notes to Condensed Consolidated Financial Statements
(unaudited)

Interim Financial Information

Basis of Presentation

The information contained herein has been prepared in accordance with instructions for Form 10-Q and Article 10 of Regulation S-X. The information 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 periods presented. The results of operations for the three and nine months ended September 30, 2008 are not necessarily indicative of expected results for the entire year ending December 31, 2008 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, 2007, included in our Annual Report on Form 10-K.

Reclassification of prior period balances

Certain amounts reported in previous periods have been reclassified to conform to current period presentation.

Inventories

Inventories are stated at the lower of cost or market, on a first-in, first-out method. Included in our inventories balance are demonstration products used by our sales representatives and marketing department. Adjustments to reduce carrying costs are recorded for obsolete material, shrinkage, earlier generation products and used or refurbished products held either as saleable inventory or as demonstration product. If market conditions change or if the introduction of new products by us impacts the market for our previously released products, we may be required to further write down the carrying cost of our inventories.

Inventories consisted of the following (in thousands):

	As of	
	September 30, 2008	December 31, 2007
Raw material	$10,291	$ 10,710
Demonstration inventory	7,697	7,601
Finished goods	11,366	11,429
Total	$29,354	$ 29,740

Warranty expense

We accrue estimated warranty expense at the time of sale for costs expected to be incurred under our product warranties. This provision for warranty expense is made based upon our historical product failure rates and service repair costs using management's judgment. We have limited history with some of our products. We provide, with certain exceptions, a five-year warranty with the MicroMaxx system, M-Turbo system and S Series ultrasound tools.

The warranty liability is summarized as follows (in thousands):

	Balance at Beginning of Period	Charged to Cost of Revenue	Applied to Liability	Balance at End of Period

Three months ended September 30, 2008	$ 5,093	$ 1,402	$ (473)	$ 6,022
Three months ended September 30, 2007	$ 3,200	$ 853	$ (428)	$ 3,625
Nine months ended September 30, 2008	$ 4,045	$ 3,239	$ (1,262)	$ 6,022
Nine months ended September 30, 2007	$ 2,317	$ 2,364	$ (1,056)	$ 3,625

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Income taxes

The income tax provision for the three and nine months ended September 30, 2008 was based on projections of total year pre-tax income and the projected total year tax provision. Deferred income taxes are provided based on the estimated future tax effects of temporary differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards arising since our inception. Deferred tax assets and liabilities are measured using enacted tax rates that are expected to apply to taxable income in the years in which those temporary differences and carryforwards are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in our tax rate is recognized in income in the period of change. The increase in our consolidated effective tax rate for the three and nine months ended September 30, 2008, as compared to 2007, results primarily from the lapsing of the U.S. research and experimentation tax credit as of December 31, 2007, non-deductible expense associated with a contingent liability incurred as part of the LumenVu acquisition, a tax assessment resulting from an income tax audit in a non-U.S. jurisdiction, an increase in executive compensation subject to Internal Revenue Code Section 162(m) limitations, and the impact of reaching the maximum federal marginal tax rate.

Net income per share

Basic net income per share is based on the weighted average number of common shares outstanding during the period. Diluted net income per share is based on the weighted average number of common and dilutive common equivalent shares outstanding during the period. Potentially dilutive common equivalent shares consist of common stock issuable upon exercise of stock options and warrants, or upon vesting of restricted stock units using the treasury stock method. Diluted net income per share would also be impacted to reflect shares issuable upon conversion of our convertible senior notes if our share price exceeds $38.20 per share. Our call option on our shares is anti-dilutive and, therefore, excluded from the calculation of diluted net income per share.

The following is a reconciliation of the numerator and denominator of the basic and diluted net income per share calculations (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Net income	$ 4,726	$ 1,487	$ 8,495	$ 2,631
Weighted average common shares outstanding used in computing basic net income per share	16,927	16,657	16,858	16,586
Effect of dilutive stock options and restricted stock units	665	531	630	515
Weighted average common shares outstanding used in computing diluted net income per share	17,592	17,188	17,488	17,101
Net income per share:				
Basic	$ 0.28	$ 0.09	$ 0.50	$ 0.16
Diluted	$ 0.27	$ 0.09	$ 0.49	$ 0.15

The following weighted average potential common equivalent shares were excluded from the computation of diluted net income per share as their effect would have been anti-dilutive (in thousands):

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Stock options	565	597	582	559
Restricted stock	3	--	1	--
Warrants (1)	2,500	2,225	2,500	744
Total weighted average potential common shares excluded from diluted net income per share	3,068	2,822	3,083	1,303

(1) As further detailed in the convertible senior notes footnote, of our December 31, 2007 Annual Report on Form 10-K, in July 2007 we issued warrants to purchase up to 2.5 million shares of our common stock with a strike price of $46.97, which are anti-dilutive since the strike price of the warrants is greater than the market price of our common stock.

The computation of diluted net income per share does not include any potential dilutive common shares associated with our convertible senior notes. The convertible senior notes would become dilutive and included in the calculation of diluted net income per share, for the number of shares that would be required to satisfy the conversion spread, if the average market price of our common stock exceeds $38.20 per share.

Accumulated other comprehensive income

Unrealized gains or losses on our available-for-sale securities that are considered temporary and foreign currency translation adjustments are included in accumulated other comprehensive income.

The following presents the components of comprehensive income (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income	$ 4,726	$ 1,487	$ 8,495	$ 2,631
Other comprehensive income:				
Foreign currency translation adjustment	(447)	(172)	(126)	(141)
Unrealized holding gains (losses) arising during the period	(147)	11	(133)	61
Comprehensive income	$ 4,132	$ 1,326	$ 8,236	$ 2,551

Indemnification Obligations and Guarantees (excluding product warranty)

We provide (i) indemnifications of varying scope and size to our customers and distributors against claims of intellectual property infringement made by third parties arising from the use of our products; (ii) indemnifications of varying scope and size to our customers against third party claims arising as a result of defects in our products; (iii) indemnifications of varying scope and size to consultants against third party claims arising from the services they provide to us; and (iv) guarantees to support obligations of some of our subsidiaries such as lease payments.

To date, we have not incurred material costs as a result of these obligations and do not expect to incur material costs in the future. Accordingly, we have not accrued any liabilities in our financial statements related to these indemnifications or guarantees.

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Fair value measurements

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measures" ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measures required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. In February 2008, the FASB issued FASB Staff Position SFAS 157-2, "Effective Date of FASB Statement No. 157" ("SFAS 157-2"), which defers the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value on a recurring basis, until fiscal years beginning after November 1, 2008 and interim periods within those fiscal years. We have adopted SFAS 157 for financial assets and liabilities effective January 1, 2008. The non-financial assets and liabilities subject to deferral include items such as goodwill and other non-amortizable intangibles. We do not believe the adoption of SFAS 157 for non-financial assets and liabilities will have a significant impact on our future consolidated financial statements.

SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 also establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three levels as follows. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs include quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on our own assumptions used to measure assets and liabilities at fair value. An asset's or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The following table provides the financial assets and liabilities that were measured at fair value as of September 30, 2008 (in thousands):

		Fair Value Measurements		
	Total Carrying Value	**Level 1**	**Level 2**	**Level 3**
Investment securities	$ 58,770	$ 54,284	$ --	$ 4,486
Long-term debt	$ 225,000	$ 232,139	$ --	$ --

Investment securities are measured at fair value using quoted market prices, with the exception of our investment in the Columbia Strategic Cash Portfolio, which is in the process of liquidation. This investment is measured at fair value, which is the net asset value of the portfolio provided by the portfolio manager. The portfolio manager has measured fair value based upon quoted market prices and quoted prices of comparable securities, as well as good faith estimates. Long-term debt is measured at fair value for disclosure only using quoted market prices. There were no changes to the valuation techniques during the three and nine months ended September 30, 2008.

Fair value measurements of Level 3 investments

	Three Months Ended September 30,	**Nine Months Ended September 30,**
Balance, at beginning of period	$ 6,460	$ 12,574
Total losses (realized or unrealized):		
Included in other income (loss)	(49)	(225)
Included in other comprehensive income	(27)	--

Transfers in or out of level 3	--	--
Sales and settlements	(1,898)	(7,863)
Balance, September 30, 2008	$ 4,486	$ 4,486
Losses included in other income (loss) attributable to the change in unrealized losses relating to assets still held	$ (43)	$ (142)

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Segment reporting

We currently have one reportable segment. We market our products in the United States and internationally through our direct sales force and our indirect distribution channels. Our chief operating decision maker evaluates resource allocation decisions and our performance based upon revenue recorded in geographic regions and does not receive financial information about expense allocation disaggregated by geographic regions. Geographic regions are determined by the shipping destination. Revenue by geographic location are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
United States	$ 33,370	$ 28,369	$ 82,985	$ 71,310
Europe, Africa and the Middle East	14,715	11,877	49,961	38,568
Latin America and Canada	6,451	4,347	18,230	12,324
Asia Pacific	7,097	5,448	22,186	18,031
Total revenue	$ 61,633	$ 50,041	$ 173,362	$ 140,233

Litigation settlement

On February 21, 2007, we filed a patent infringement suit against Zonare Medical Systems, Inc. ("Zonare") in the federal district court of the Central District of California alleging that Zonare infringed our U.S. patent 5,722,412 through sales of its z.one ultrasound system. On March 14, 2007, Zonare filed an answer to our claim which included a counterclaim against us alleging that our products infringe its U.S. patent 6,980,419 related to its portab