SONOSITE INC
Form 10-Q
August 03, 2009

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 June 30, 2009
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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [ ] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer 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	17,285,328
(Class)	(Outstanding as of July 17, 2009)

SonoSite, Inc.
Quarterly Report on Form 10-Q
For the Quarter Ended June 30, 2009
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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

SonoSite, Inc.
Condensed Consolidated Balance Sheets
(unaudited)

(In thousands, except share data)

	June 30, 2009	December 31, 20008 As Adjusted
Assets		
Current assets:		
Cash and cash equivalents	$ 193,866	$ 209,258
Short-term investment securities	69,049	69,882
Accounts receivable, less allowances of $1,980 and $2,190	54,102	66,094
Inventories	30,243	29,115
Deferred income taxes, current	12,688	13,372
Prepaid expenses and other current assets	7,583	6,623
Total current assets	367,531	394,344
Property and equipment, net	8,752	8,955
Investment securities	488	578
Goodwill	3,902	3,767
Deferred income taxes	814	793
Identifiable intangible assets, net	12,951	13,062
Other assets	4,302	5,383
Total assets	$ 398,740	$ 426,882
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 6,561	$ 6,189
Accrued expenses	20,494	31,921
Deferred revenue, current portion	2,606	2,755
Total current liabilities	29,661	40,865
Long-term debt, net	94,330	111,336
Deferred tax liability, net	6,716	9,871
Other non-current liabilities	13,922	13,750
Total liabilities	144,629	175,822
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 June 30, 2009—17,277,973	173	
As of December 31, 2008—17,054,697		171
Additional paid-in-capital	288,901	285,757
Accumulated deficit	(34,747)	(36,036)

Accumulated other comprehensive income (loss)		(216	)		1,168
Total shareholders' equity		254,111			251,060
Total liabilities and shareholders' equity	$	398,740		$	426,882

See accompanying notes to condensed consolidated financial statements.

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

(In thousands, except net income per share)	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008 As Adjusted	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008 As Adjusted
Revenue	$ 52,285	$ 59,230	$ 104,090	$ 111,729
Cost of revenue	15,299	17,741	32,012	32,400
Gross margin	36,986	41,489	72,078	79,329
Operating expenses:				
Research and development	7,375	6,937	15,072	13,134
Sales, general and administrative	27,584	29,209	53,387	58,458
Licensing income and litigation settlement	(924)	--	(924)	--
Total operating expenses	34,035	36,146	67,535	71,592
Other income (loss)				
Interest income	588	2,128	1,537	4,954
Interest expense	(2,349)	(4,303)	(4,943)	(8,565)
Other	(508)	(711)	933	(1,326)
Total other loss, net	(2,269)	(2,886)	(2,473)	(4,937)
Income before income taxes	682	2,457	2,070	2,800
Income tax provision	257	1,046	782	1,199
Net income	$ 425	$ 1,411	$ 1,288	$ 1,601
Net income per share:				
Basic	$ 0.02	$ 0.08	$ 0.08	$ 0.10
Diluted	$ 0.02	$ 0.08	$ 0.07	$ 0.09
Weighted average common and potential common shares outstanding:				
Basic	17,219	16,843	17,150	16,806
Diluted	17,619	17,456	17,567	17,429

See accompanying notes to condensed consolidated financial statements.

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

	Six Months Ended June 30,	
(In thousands)	2009	2008 As Adjusted
Operating activities:		
Net income	$ 1,288	$ 1,601
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	2,109	2,088
Stock-based compensation	3,943	3,467
Deferred income tax provision	863	1,845
Amortization of net discounts on investment securities	(301)	(1,070)
Amortization of debt discount and debt issuance costs	2,559	4,364
Accretion of contingent purchase consideration	480	450
Excess tax benefit from exercise of stock based awards	--	(767)
Net gain on investments	(13)	(3)
Gain on convertible note repurchase	(1,339)	--
Non-cash gain on litigation settlement	(924)	--
Loss on disposal of property and equipment	29	--
Investment other-than-temporary impairment	4	179
Changes in operating assets and liabilities:		
Accounts receivable	12,347	1,867
Inventories	(966)	(3,169)
Prepaid expenses and other assets	236	(255)
Accounts payable	333	(4,632)
Accrued expenses	(12,734)	(865)
Deferred liabilities	(541)	(122)
Net cash provided by operating activities	7,374	4,978
Investing activities:		
Purchases of investment securities	(67,786)	(162,973)
Proceeds from sales/maturities of investment securities	68,843	151,369
Purchases of property and equipment	(1,810)	(1,255)
Earn-out consideration associated with SonoMetric acquisition	(387)	(921)
Net cash used in investing activities	(1,140)	(13,780)
Financing activities:		
Excess tax benefit from stock-based awards	--	767
Minimum tax withholdings on stock-based awards	(852)	--
Proceeds from exercise of stock-based awards	1,385	2,019
Repurchase of convertible senior notes	(20,500)	--
Proceeds from sale of call options	1,409	--
Repurchase of warrants	(1,325)	--
Net cash (used in) provided by financing activities	(19,883)	2,786
Effect of exchange rate changes on cash and cash equivalents	(1,743)	(1,037)
Net change in cash and cash equivalents	(15,392)	(7,053)
Cash and cash equivalents at beginning of period	209,258	188,701

Cash and cash equivalents at end of period	$	193,866	$	181,648
Supplemental disclosure of cash flow information:				
Cash paid for income taxes	$	2,457	$	1,200
Cash paid for interest	$	2,812	$	4,195

See accompanying notes to condensed consolidated financial statements.

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 six months ended June 30, 2009 are not necessarily indicative of expected results for the entire year ending December 31, 2009 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, 2008, included in our Annual Report on Form 10-K.

Adjustment of prior period balances

Certain amounts reported in comparable prior periods have been adjusted due to the adoption of Financial Accounting Standards Board Staff Position (FSP) No. APB 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)" ("APB 14-1") on January 1, 2009. For additional detail on the adjusted balances, refer to the Change in Accounting Principle footnote.

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	
	June 30, 2009	December 31, 2008
Raw material	$ 10,974	$ 10,007
Demonstration inventory	8,195	8,198
Finished goods	11,074	10,910
Total	$ 30,243	$ 29,115

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 provide, with certain exceptions, a five-year warranty with the MicroMaxx system, M-Turbo system, S Series, and NanoMaxx ultrasound tools.

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

	Beginning of Period	Charged To Cost of Revenue	Applied to Liability	End of Period
Three months ended June 30, 2009	$7,486	$1,041	$(627)	$7,900
Three months ended June 30, 2008	$4,366	$1,186	$(459)	$5,093
Six months ended June 30, 2009	$7,094	$2,037	$(1,231)	$7,900
Six months ended June 30, 2008	$4,045	$1,828	$(780)	$5,093

Income taxes

The income tax provisions for the three and six months ended June 30, 2009 are 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. 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 decrease in our consolidated effective tax rate for the three and six months ended June 30, 2009, as compared to 2008, results primarily from the reinstatement of the U.S. research and development tax credit in late 2008 and our qualification for the domestic production activities tax deduction.

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 June 30,		Six Months Ended June 30,	
	2009	2008 As Adjusted	2009	2008 As Adjusted
Net income	$ 425	$ 1,411	$ 1,288	$ 1,601
Weighted average common shares outstanding used in computing basic net income per share	17,219	16,843	17,150	16,806

Effect of dilutive stock options and restricted stock units		400		613		417		623
Weighted average common shares outstanding used in computing diluted net income per share		17,619		17,456		17,567		17,429
Net income per share:								
Basic	$	0.02	$	0.08	$	0.08	$	0.10
Diluted	$	0.02	$	0.08	$	0.07	$	0.09

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):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Stock options and restricted stock units	1,400	736	1,475	686
Warrants outstanding	1,184	2,500	1,184	2,500
Total common shares excluded from diluted net income per share	2,584	3,236	2,659	3,186

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 (loss) (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008 As Adjusted	2009	2008 As Adjusted
Net income	$ 425	$ 1,411	$ 1,288	$ 1,601
Other comprehensive (loss) income:				
Foreign currency translation adjustment	(1,383)	(5)	(1,280)	321
Unrealized gains (losses) arising during the period	64	(97)	(104)	14
Comprehensive (loss) income	$ (894)	$ 1,309	$ (96)	$ 1,936

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.

Cash, cash equivalents and investment securities

Effective April 1, 2009, we adopted FSP No. FAS 115-2 and FAS 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments," which amends the other-than-temporary impairment guidance for debt securities and changes the existing impairment model for such securities. It also modifies the presentation of other-than-temporary losses and increases the frequency of and expands the required disclosures related to other-than-temporary impairments.

The following table summarizes our cash, cash equivalents and investment securities at fair value (in thousands):

		June 30, 2009		December 31, 2008
Cash	$	11,620	$	13,921
Cash equivalents:				
Corporate debt securities		14,293		59,947
Other debt obligations	$	167,953	$	135,390
Total cash and cash equivalents	$	193,866	$	209,258
Investment securities				
Short-term	$	69,049	$	69,882
Long-term	$	488	$	578

Cash and cash equivalents primarily consist of money market accounts with major U.S. banks and highly liquid debt instruments with maturities at purchase of three months or less. Investment securities primarily consist of high-grade U.S. government or corporate debt and high-grade asset backed securities. We have the ability to hold our securities until maturity; however, we classify all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies. Realized gains and losses from the sale of available-for sale securities are determined on a specific identification basis.

As of June 30, 2009 and December 31, 2008, we had $1.8 million and $2.8 million invested in Columbia Strategic Cash Portfolio, which is in the process of liquidation. Distributions from this portfolio are solely at the discretion of the portfolio manager. This investment is measured at fair value, which is the net asset value of the portfolio provided by the portfolio manager. Other-than-temporary impairments, all of which relate to the Columbia Strategic Cash Portfolio, represent credit losses and have been recognized in other income (loss) with no amount recorded in accumulated other comprehensive income. We anticipate that $1.3 million, which is recorded as short-term for this investment, will be distributed from this portfolio during the next twelve months, and $0.5 million, which is recorded as a long-term investment, will be distributed thereafter. All other investments will mature in 2009.

The amortized cost, gross unrealized holding gains and losses and fair value of investment securities classified as available-for-sale securities were as follows (in thousands):

	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
As of June 30, 2009:				
Cash equivalents:				
Corporate debt securities	$14,284	$9	$--	$14,293
Other debt obligations	167,953	--	--	167,953
Total cash equivalents	$182,237	$9	$--	$182,246
Short-term:				
Corporate debt securities	$67,601	$75	$--	$67,676
Other debt obligations	1,302	71	--	1,373
Total short-term investments	$68,903	$146	$--	$69,049
Long-term:				
Other debt obligations	$462	$26	$--	$488
Total long-term investments	$462	$26	$--	$488
As of December 31, 2008:				
Cash equivalents:				
Corporate debt securities	$59,829	$118	$--	$59,947
Other debt obligations	135,390	--	--	135,390
Total cash equivalents	$195,219	$118	$--	$195,337
Short-term:				
Corporate debt securities	$67,129	$234	$--	$67,363
Other debt obligations	2,251	--	(2)	2,519
Total short-term investments	$69,650	$234	$(2)	$69,882
Long-term:				
Other debt obligations	$578	$--	$--	$578
Total long-term investments	$578	$--	$--	$578

The following table summarizes our realized gains and losses on sales and redemptions of investments (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Gains	11	8	13	8
Losses	--	(31)	(4)	(184)
Realized gain (loss), net	11	23	9	(176)

For the three and six months ended June 30, 2009 and 2008, all realized gains resulted from distributions in excess of the amortized cost value of our Columbia Strategic Cash Portfolio.

The following table summarizes our gross unrealized gains and losses on investment securities included in accumulated other comprehensive income (in thousands):

	As of June 30, 2009	As of December 31, 2008
Gains	$ 181	$ 348
Losses	--	--
Gross unrealized gains (losses)	$ 181	$ 348

Fair value measurements

The following table provides the financial assets and liabilities that were measured at fair value as of June 30, 2009 (in thousands):

	Total Carrying Value	Fair Value Measurements Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Investment Securities				
Corporate debt securities	$ 67,675	$ 67,675	$ --	$ --
Other debt obligations	1,861	50	--	1,811
Total investment securities	$ 69,536	$ 67,725	$	$ 1,811
Long-term debt, net	$ 94,330	$ 100,976	$ --	$ --

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 six months ended June 30, 2009. The carrying value of long-term debt was reduced as the result of the adoption of APB 14-1. See Change in Accounting Principle for additional information.

We perform impairment tests on certain assets, including goodwill and intangible assets at fair value on a nonrecurring basis annually in the fourth quarter or if and when a triggering event occurs. If there is an impairment, these assets would be measured at fair value. For the period ended June 30, 2009, there were no impairments recorded for goodwill and intangible assets.

Fair value measurements of Level 3 investments

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Balance, at beginning of period	$ 1,990	$ 8,189	$ 2,765	$ 12,574
Total gain (loss) (realized or unrealized) included in:				
Other income (loss)	11	(23)	8	(176)
Other comprehensive income	77	27	97	27
Sales and settlements	(267)	(1,733)	(1,059)	(5,965)
Balance, at end of period	$ 1,811	$ 6,460	$ 1,811	$ 6,460
Gains (losses) included in other income (loss) attributable to the change in unrealized losses relating to assets still held	$ 11	$ (25)	$ 8	$ (140)

Change in Accounting Principle

Effective January 1, 2009, we adopted APB 14-1, which clarifies the accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. APB 14-1 requires issuers to account separately for the liability and equity components of certain convertible debt instruments in a manner that reflects the issuer's nonconvertible debt borrowing rate when interest cost is recognized. APB 14-1 requires bifurcation of a component of the conversion option, classification of that component in equity and the accretion of the resulting discount on the debt to be recognized as part of interest expense in our consolidated statement of income. APB 14-1 requires retrospective application to the terms of instruments as they existed for all periods presented. Our debt offering completed in July 2007 of $225.0 million aggregate principal amount of 3.75% convertible senior notes ("Notes") falls within the scope of APB 14-1.

Upon issuance of the Notes and prior to the adoption of APB 14-1, we evaluated the Notes using the "Working Draft of AICPA Technical Practice Aid" ("Technical Practice Aid") prepared by the Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments Task Force to consider whether the conversion option on the Notes met the criteria to preclude recognition as a debt discount. We concluded the conversion feature should be equity classified and not recorded as a standalone derivative, and thus the conversion feature was exempt from bifurcation. Debt issuance costs of $7.5 million were being amortized to interest expense over the term of the Notes.

Upon adoption of APB 14-1, we were required to bifurcate a component of the conversion option. We calculated the fair value of the liability component of the Notes using a discount rate of similar liabilities without conversion features and determined the carrying amount of the equity component by deducting the fair value of the liability component from the initial carrying value of the convertible debt. This resulted in an initial recognition of $63.9 million of debt discount, to be amortized over a seven year period at an effective interest rate of 8.5%, and a corresponding deferred tax liability of $23.6 million. Additionally, $2.1 million of debt issuance costs, included in other assets in our consolidated balance sheet, were reclassified to equity on a proportionate basis as the equity component. The adoption of APB 14-1 did not require any changes to the treatment of our call options and warrants that had been previously classified as equity.

As a result of adopting APB 14-1, the change in accounting principle had the following effect on prior year balances (in thousands except per share data):

	Three Months Ended June 30, 2008		Six Months Ended June 30, 2008	
	As Adjusted	As Reported	As Adjusted	As Reported
Selected Statement of Income Data				
Operating income	$ 5,343	$ 5,343	$ 7,737	$ 7,737
Total other loss	(2,886)	(956)	(4,937)	(1,107)
Income before income taxes	2,457	4,387	2,800	6,630
Income tax provision	1,046	1,863	1,199	2,861
Net income	$ 1,411	$ 2,524	$ 1,601	$ 3,769
Net income per share:				
Basic	$ 0.08	$ 0.15	$ 0.10	$ 0.22
Diluted				