

SONOSITE INC  
Form 10-Q  
August 03, 2009

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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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

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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]

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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)

17,285,328  
(Outstanding as of July 17, 2009)

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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)

Assets	June 30, 2009	December 31, 2008 As Adjusted
<b>Current assets:</b>		
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
<b>Total current assets</b>	<b>367,531</b>	<b>394,344</b>
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
<b>Total assets</b>	<b>\$ 398,740</b>	<b>\$ 426,882</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 6,561	\$ 6,189
Accrued expenses	20,494	31,921
Deferred revenue, current portion	2,606	2,755
<b>Total current liabilities</b>	<b>29,661</b>	<b>40,865</b>
Long-term debt, net	94,330	111,336
Deferred tax liability, net	6,716	9,871
Other non-current liabilities	13,922	13,750
<b>Total liabilities</b>	<b>144,629</b>	<b>175,822</b>
<b>Commitments and contingencies</b>		
<b>Shareholders' equity:</b>		
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 )

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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.

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

(In thousands, except net income per share)	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008 As Adjusted	2009	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.

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

(In thousands)	Six Months Ended June 30,	
	2009	2008 As Adjusted
<b>Operating activities:</b>		
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
<b>Investing activities:</b>		
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)
<b>Financing activities:</b>		
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

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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):

	June 30, 2009	As of 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

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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

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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.

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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

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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	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)
<b>Investment Securities</b>				
Corporate debt securities	\$ 67,675	\$ 67,675	\$ --	\$ --
Other debt obligations	1,861	50	--	1,811
<b>Total investment securities</b>	<b>\$ 69,536</b>	<b>\$ 67,725</b>	<b>\$ --</b>	<b>\$ 1,811</b>
<b>Long-term debt, net</b>				
	\$ 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,		Six Months Ended June 30,	
	2009	2008	2009	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
<b>Selected Statement of Income Data</b>				
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
<b>Net income per share:</b>				
Basic	\$ 0.08	\$ 0.15	\$ 0.10	\$ 0.22
Diluted	\$ 0.08	\$ 0.14	\$ 0.09	\$ 0.22

Shares used in computing net income per share:				
Basic	16,843	16,843	16,806	16,806
Diluted	17,456	17,456	17,429	17,429

We recognized an additional \$1.9 million and \$3.8 million in interest expense for the three and six months ended June 30, 2008. The additional interest expense was primarily related to the amortization of the debt discount. Interest expense related to the contractual coupon was \$2.1 million and \$4.2 million for the three months and six months ended June 30, 2008.

The adoption of APB 14-1 also resulted in changes in our consolidated balance sheet for the year ended December 31, 2008 as follows (in thousands):

Condensed Balance Sheet Data	Year Ended December 31, 2008	
	As Adjusted	As Reported
Total current assets	\$ 394,344	\$ 390,327
Total non-current assets	32,538	38,960
<b>Total assets</b>	<b>\$ 426,882</b>	<b>\$ 429,287</b>
Total current liabilities	\$ 40,865	\$ 40,865
Total non-current liabilities	134,957	158,495
<b>Total liabilities</b>	<b>\$ 175,822</b>	<b>\$ 199,360</b>
Common stock	\$ 171	\$ 171
Additional paid-in capital	285,757	252,895
Accumulated deficit	(36,036)	(24,307)
Accumulated other comprehensive income	1,168	1,168
<b>Total liabilities and shareholders' equity</b>	<b>\$ 426,882</b>	<b>\$ 429,287</b>

Current assets increased by \$4.0 million due to an increase in the deferred tax benefit related to debt issuance costs. Non-current assets decreased by \$6.4 million due to the reclassification of \$5.3 million in deferred tax assets to offset deferred tax liabilities and a \$1.1 million reclassification of debt issuance costs to equity. Non-current liabilities decreased by \$23.5 million due to a \$33.4 million reclassification of the equity component of long-term debt to additional paid-in capital, offset by a net increase in deferred tax liabilities of \$9.9 million. Equity balances were primarily affected by the reclassifications noted above and lower net income resulting from a decrease of \$7.4 million in gains on repurchase, a cumulative interest expense from 2007 and 2008 of \$11.1 million, offset by a \$6.8 million reduction in provision for income taxes.

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The following table summarizes the impact of the adoption of APB 14-1 on the affected balances within shareholders' equity (in thousands):

	Additional paid-in capital (1)	Accumulated deficit
Balance at December 31, 2007, as reported	\$ 236,158	\$ (44,893)
Adjustments for adoption of APB 14-1 to 2007		
Equity component of convertible debt	63,886	--
Deferred tax liability related to equity component	(23,580)	--
Debt issuance costs, net of deferred tax benefit of \$784	(1,341)	--
Net income adjustment	--	(2,365)
Balance at December 31, 2007, as adjusted	\$ 275,123	\$ (47,258)
Balance at December 31, 2008, as reported	\$ 252,895	\$ (24,307)
Cumulative impact from 2007 adjustments	38,965	(2,365)
Adjustments for adoption of APB 14-1 to 2008		
Repurchase of convertible debt attributed to the equity component	(10,942)	--
Repurchase impact on deferred tax liability related to the equity component	7,012	--
Tax provision related to cancellation of debt	(2,173)	--
Net income adjustment	--	(9,364)
Balance at December 31, 2008, as adjusted	\$ 285,757	\$ (36,036)

(1) Balances include treasury stock of \$133

The following table summarizes the carrying value of the debt and equity components subsequent to the adoption of APB 14-1 (in thousands):

	June 30, 2009	As of December 31, 2008
Equity component	\$ 33,686	\$ 34,746
Senior convertible debt:		
Outstanding	\$ 119,745	\$ 144,745
Debt Discount	25,415	33,409
Long term debt, net	\$ 94,330	\$ 111,336

Upon repurchase or settlement of our Notes, we revalue the liability component, utilizing an interest rate of comparable nonconvertible debt. We allocate a portion of the consideration transferred to the liability component equal to the fair value of that component immediately prior to repurchase. Any difference between the consideration attributed to the liability component and the sum of the net carrying amount of the liability component and unamortized debt issuance costs is recognized as a gain or loss in the statement of income. Any remaining consideration is allocated to the reacquisition of the equity component and is recognized as a reduction of stockholders' equity.

In the first quarter of 2009, we repurchased \$25.0 million in principal amount of our Notes for \$20.5 million. As a result of these repurchases, we recorded a gain of \$1.3 million in other income, net of deferred financing costs of \$0.5 million and costs to complete the repurchase transaction. We also partially unwound the associated convertible note hedges, which resulted in proceeds to us of approximately \$1.4 million for the sale of call options, offset by \$1.3 million we paid for the repurchase of warrants. Following the repurchases, unamortized debt issuance costs approximated \$2.1 million. Interest expense for the first quarter of 2009 consisted of \$1.3 million related to the amortization of debt discount and debt issuance costs and \$1.3 million related to the contractual interest coupon. The

remaining discount of \$26.5 million will be amortized over 5 years.

Interest expense related to the amortization of debt discount and debt issuance costs was \$1.2 million for the three months ended June 30, 2009 and \$2.6 million year to date. Interest expense related to the contractual coupon was \$1.1 million and \$2.4 million for the three and six months ended June 30, 2009.

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Additionally, during the first quarter of 2009, the carrying value of the equity component was reduced by \$2.9 million, the allocated amount from repurchases of our senior convertible debt, and \$0.2 million from the write-off of the deferred tax asset related to debt issuance costs, offset by a \$2.1 million reduction of the deferred tax liability related to the debt discount. These were noncash items from the repurchase transaction.

In the fourth quarter of 2008, we repurchased \$80.3 million in principal amount of our senior convertible notes for \$62.4 million. As a result of these repurchases, we recorded a gain, net of deferred financing costs and costs to complete the repurchase transaction, of \$8.2 million in other income, or \$15.7 million in other income prior to adoption of APB 14-1. The payment received from partially unwinding the associated convertible note hedges resulted in proceeds to us of approximately \$6.4 million, offset by \$5.9 million we paid for the repurchase of warrants. The transaction also resulted in a write off of \$1.5 million of debt issuance costs, or \$2.2 million prior to adoption of APB 14-1. Following the repurchases, debt issuance costs approximated \$2.7 million, or \$3.9 million prior to the adoption of APB 14-1.

In July 2007, we completed the offering of the Notes, which are due in 2014. The Notes may be converted, under certain circumstances described below, based on an initial conversion rate of 26.1792 shares of common stock per \$1,000 principal amount of notes (which is equivalent to an initial conversion price of approximately \$38.20 per share). The net proceeds from the issuance of the Notes were \$217.6 million, after deducting debt issuance costs. The Notes have no restrictive covenants and the if-converted value is approximately equivalent to the current principal outstanding.

The net proceeds from the issuance of the Notes, net of issuance costs, the convertible note hedge transaction, and the warrant transaction were \$208.5 million.

We pay cash interest on the Notes at an annual rate of 3.75%, payable semi-annually on January 15 and July 15 of each year, which began on January 15, 2008.

In connection with the offering, we used a portion of the offering proceeds to enter into a convertible note hedge transaction whereby we purchased a call option for up to 2.5 million shares of our common stock at a price of \$38.1982 per share. These options, which hedge approximately 42% of the risk of additional share issuance, expire on July 15, 2014 and must be settled in net shares. The cost of the call option was \$28.6 million and has been recorded as a reduction to stockholders' equity. The tax benefit from the deduction related to the purchase of the call option as part of the convertible note hedge transaction is recorded to additional paid in capital over the term of the hedge transaction.

Additionally, to partially offset the cost of the convertible note hedge transaction, we sold warrants to purchase up to 2.5 million shares of our common stock at a price of \$46.965 per share. The warrants expire on various dates from October 15, 2014 through the 60th scheduled trading day following October 15, 2014 and must be settled in net shares. We received approximately \$19.5 million in cash proceeds from the sales of these warrants and they were recorded as an increase to stockholders equity.

Holder of our remaining outstanding Notes may convert their Notes based on an initial conversion rate of 26.1792 shares of our common stock per \$1,000 principal amount of notes, subject to adjustment, at their option at any time prior to April 15, 2014 under the following circumstances: (1) during any fiscal quarter beginning after September 30, 2007 (and only during such fiscal quarter), if the last reported sale price of our common stock for at least 20 trading days during the 30 consecutive trading days ending on the last trading day of the immediately preceding fiscal quarter is greater than or equal to 130% of the applicable conversion price on each applicable trading day of such preceding fiscal quarter; (2) during the five business day period after any ten consecutive trading day period in which the trading price per note for each day of that ten consecutive trading day period was less than 98% of the product of the last reported sale price of our common stock and the conversion rate on such day; or (3) upon the occurrence of specified

corporate transactions. On or after April 15, 2014, holders may convert their Notes at any time prior to the close of business on the third scheduled trading day immediately preceding the maturity date.

Upon conversion, we will pay cash and shares of our common stock, if any, based on a daily conversion rate multiplied by a volume weighted average price of our common stock during a specified period following the conversion date. Conversions will be settled in cash up to the principal amount of the Notes, with any conversion value above the principal amount settled in shares of our common stock. Holders of the Notes may require us to repurchase the notes for cash equal to 100% of the principal amount to be repurchased plus accrued and unpaid interest upon the occurrence of a fundamental change. In addition, we will adjust the conversion rate for holders who elect to convert notes in connection with a fundamental change. We may not redeem any of the Notes at our option prior to maturity.



## Hedging activities

On January 1, 2009, we adopted Financial Accounting Standards Board (“FASB”) Statement No.161, “Disclosures about Derivative Instruments and Hedging Activities” which requires enhanced disclosures regarding an entity’s derivative and hedging activities. We enter into derivative transactions to hedge certain foreign currency exposures. The currencies hedged were the British pound, the European Union euro, the Japanese yen, the Australian dollar and the Canadian dollar.

We utilize foreign currency forward contract to offset foreign currency risk associated with our intercompany balances denominated in a currency other than the USD on our balance sheet. As of June 30, 2009, we had \$43.6 million in notional amount of foreign currency forward contracts expiring July 31, 2009. The fair value of these contracts as of June 30, 2009 was not material to our results of operations or financial position.

During the second quarter of 2009, we also began using foreign currency forward contracts to hedge the impact of currency fluctuations on the translation of the financial statements of our foreign operations. As of June 30, 2009, we had \$6.8 million in notional amount of foreign currency forward contracts expiring at various dates through December 31, 2009. These derivatives are not eligible for hedge accounting treatment and changes in the fair value of these derivatives are recorded in other income on the consolidated statement of income. The fair value of these contracts as of June 30, 2009 was not material to our results of operations or financial position.

Recognized gains and losses, which are included in other income on the consolidated statement of income, are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Foreign currency hedges	\$ (3,166)	\$ 76	\$ (751)	\$ (2,480)
Intercompany receivables	2,884	(543)	818	1,777
Net gain (loss) related to hedge activities	\$ (282)	\$ (467)	\$ 67	\$ (703)

## 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 June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
United States	\$ 23,888	\$ 28,258	\$ 47,120	\$ 50,392
Europe, Africa and the Middle East	14,083	15,698	28,346	33,179
Latin America and Canada	5,280	5,513	10,049	11,390
Asia Pacific	9,034	9,761	18,576	16,768
Total revenue	\$ 52,285	\$ 59,230	\$ 104,090	\$ 111,729

## Contingencies

On May 15, 2007, GE Healthcare (“GE”) filed a lawsuit against us in the federal district court in the Western District of Wisconsin. The lawsuit alleged that certain of our products willfully infringed certain of GE’s U.S. patents relating to ultrasound technology. We filed a counterclaim against GE and certain of its affiliates, and filed an answer denying all of GE’s claims and alleging that the asserted patents are either invalid, not infringed, or both. In rulings issued on July 24, 2008, the trial judge granted summary judgment motions in our favor on five of the six patents that GE had asserted against us. The court ruled that one of the GE patents is invalid and that our products do not infringe the other four GE patents. The trial judge also granted summary judgment in GE’s favor on two of our four asserted patents finding that GE’s accused products did not infringe our asserted patents. On July 28, 2008 the parties filed a stipulation for dismissal without prejudice for the remaining claims and counterclaims for the three remaining patents that have yet to be ruled on by summary judgment in this case, thereby negating the need for a trial. On July 31, 2008, the court granted the parties’ request for dismissal of the remaining claims and counterclaims that had not been ruled on by the judge.

The parties have appealed certain of the trial court’s summary judgment decisions and other rulings to the Court of Appeals for the Federal Circuit. Oral argument at the Federal Circuit took place in early July. We expect an appellate decision later this year.

On May 22, 2008, GE filed a second suit in the same federal court in Wisconsin seeking to invalidate our U.S. patent 5,722,412. We have counterclaimed that the new ultrasound systems GE proposes to market and sell infringe this patent. The trial was held in early June 2009 and post trial briefing took place during the month of July. We expect a decision to be issued later this year.

We have not accrued any amounts for potential losses related to these matters. Because of uncertainties related to the potential outcome and any range of loss on the pending litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability related to these matters. If and when we determine that a negative outcome of such matters is probable and reasonably estimable we will record accruals for losses. Our estimates regarding such losses could differ from actual results. Revisions in our estimates of the potential liability could materially impact our results of operations, financial position and cash flow. We expense legal costs as incurred.

## Pending transaction

In June 2009, we reached an agreement to acquire CardioDynamics International Corporation (“CardioDynamics”). Under the terms of the agreement, we will acquire CardioDynamics in exchange for \$1.35 per share in cash. The aggregate transaction value will be approximately \$10.0 million, or \$12.3 million net of acquired cash and debt. The acquisition is conditioned upon approval by CardioDynamics’ shareholders as well as the satisfaction of all other customary conditions. Approval by our shareholders is not required. The transaction is expected to close in the third quarter of 2009.

## Adjustments

Our results for the six months ended June 30, 2009 include correction of various prior year errors deemed immaterial in 2008. These corrections had the effect of decreasing revenue by \$0.1 million and net income by \$0.3 million (\$0.02 earnings per diluted share) for six months ended June 30, 2009. These corrections were not deemed material to the estimated full year financial results for 2009.

### Subsequent events

In July 2009, we received final consideration for a Settlement Agreement entered in 2008 with Zonare Medical Systems, Inc. (“Zonare”). Under the Settlement Agreement, our claims associated with a patent infringement suit related to Zonare’s z.one ultrasound system and Zonare’s counterclaim related to portable docking stations were dismissed for cross-licenses of certain patents between the parties and a \$3.25 million payment from Zonare to SonoSite. We received a \$2.0 million payment in July 2008 and a note receivable for the remaining \$1.25 million, which was recorded at \$0.3 million, reflecting our judgment of collection risk. We recognized a benefit of \$0.9 million in operating income for the three and six months ended June 30, 2009 considering final payment was received in July 2009. Subsequent events have been measured through August 3, 2009, the date of issuance of our condensed consolidated financial statements.

### Recent accounting pronouncements

In May 2009, the FASB issued Statement No. 165, “Subsequent Events” (“SFAS 165”), which requires additional disclosure surrounding the date through which an entity has evaluated subsequent events. Public entities are required to evaluate subsequent events through the date the financial statements are issued. SFAS 165 will not have an impact on our current practice of measuring subsequent events.

In June 2009, the FASB issued Statement No. 167, “Amendments to FASB Interpretation No. 46(R)” (“SFAS 167”), which amends FIN 46(R), “Consolidation of Variable Interest Entities,” and changes the consolidation guidance applicable to a variable interest entity (“VIE”). It also amends the guidance governing the determination of whether an enterprise is the primary beneficiary of a VIE, and is, therefore, required to consolidate an entity, by requiring a qualitative analysis rather than a quantitative analysis. The qualitative analysis will include, among other things, consideration of who has the power to direct the activities of the entity that most significantly impact the entity’s economic performance and who has the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE. This standard also requires continuous reassessments of whether an enterprise is the primary beneficiary of a VIE. Previously, FIN 46(R) required reconsideration of whether an enterprise was the primary beneficiary of a VIE only when specific events had occurred. SFAS 167 also requires enhanced disclosures about an enterprise’s involvement with a VIE. SFAS 167 becomes effective for interim and annual reporting periods that begin after November 15, 2009. We currently do not have any VIEs nor do we anticipate acquiring any in our recently announced acquisition. As such, we do not expect that the adoption of this standard will impact our current fiscal year.

In June 2009, the FASB issued Statement No. 168, “The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162” (“SFAS 168”), which makes the FASB Accounting Standards Codification™ (“Codification”) the source of authoritative U.S. generally accepted accounting principles (“GAAP”) recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases issued by the Securities and Exchange Commission are also authoritative GAAP for SEC registrants, while all other non-SEC accounting literature not included in the Codification will become nonauthoritative. SFAS 168 does not change U.S. GAAP for public entities; however, referencing of authoritative literature will change in future filings. SFAS 168 becomes effective for financial statements issued for interim and annual periods ending after September 15, 2009.

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

This quarterly report on Form 10-Q contains forward-looking statements. Forward-looking statements provide our current expectations or forecasts of future events. Forward-looking statements in this report include, without limitation:

- information concerning possible or assumed future results of operations, trends in financial results and business plans, including those relating to earnings growth and revenue growth;
- statements about the level of our costs and operating expenses relative to our revenues, and about the expected composition of our revenues;
- statements about our future capital requirements and the sufficiency of our cash, cash equivalents, investments and available bank borrowings to meet these requirements;
- other statements about our plans, objectives, expectations and intentions; and
- other statements that are not historical facts.

Words such as “believe,” “anticipate,” “expect” and “intend” may identify forward-looking statements, but the absence of these words does not necessarily mean that a statement is not forward-looking. Forward-looking statements are subject to known and unknown risks and uncertainties, and are based on potentially inaccurate assumptions that could cause actual results to differ materially from those expected or implied by the forward-looking statements. You should not unduly rely on these forward-looking statements, which speak only as of the date of this report.

We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures we make on related subjects in our future quarterly reports on Form 10-Q, current reports on Form 8-K and annual reports on Form 10-K. Also note that we provide a cautionary discussion of risks, uncertainties and possibly inaccurate assumptions relevant to our business in Item 1A. “Risk Factors” section of our Annual Report on Form 10-K for the year ended December 31, 2008. These are risks that could cause our actual results to differ materially from those anticipated in our forward-looking statements or from our expected or historical results. Other factors besides the risks, uncertainties and possibly inaccurate assumptions described in this report could also affect actual results.

### Overview

The following Management's Discussion and Analysis (“MD&A”) is intended to help the reader understand the results of operations and financial condition of SonoSite, Inc. MD&A is provided as a supplement to, and should be read in conjunction with, our consolidated financial statements and the accompanying notes to the consolidated financial statements

Our business strategy is to lead in the design, development and commercialization of high performance, innovative ultrasound technology and hand carried ultrasound systems. We intend to sustain long-term growth of our business through technological innovation, broadening of sales distribution channels, entry and maintenance of strategic relationships, expanding into new clinical and geographic markets, and delivering high-quality products to customers. We are focusing on the development of innovative products with the objective of improving patient care and efficiency through ease of use, high performance imaging, and providing quicker results to physicians and clinicians. We are also investing in research and development in existing and new lines of business and other areas that we believe may contribute to our long-term growth. Recognizing that one of our greatest challenges is the current state of the global economy, we are focused on increasing sales force efficiency and effective cost management.

Over the last few years, we have laid a foundation for long-term growth by introducing innovative products, entering into strategic relationships, expanding into new markets, and providing high quality products with an industry-leading 5-year warranty. In fiscal year 2009, we plan to continue to build on this foundation and to execute well in key areas,

including continuing to innovate using existing and new technologies, to build and maintain key relationships in the sales distribution channels, to improve sales force productivity, to deliver high quality products, and to manage expenses.

In June 2009, we reached an agreement to acquire CardioDynamics International Corporation (“CardioDynamics”). Under the terms of the agreement, we will acquire CardioDynamics in exchange for \$1.35 per share in cash. The aggregate transaction value will be approximately \$10.0 million, or \$12.3 million net of acquired cash and debt. The acquisition is conditioned upon approval by CardioDynamics’ shareholders as well as the satisfaction of all other customary conditions. Approval by our shareholders is not required. The transaction is expected to close in the third quarter of 2009.

During the quarter, we also introduced the NanoMaxx™, a 6 pound ultrasound tool designed for diagnostic imaging, clinical assessment, and procedural guidance at hospital beds and in the physician's office. This latest addition to our suite of products features one-button system control.

#### Results of Operations

#### Revenue

Revenue decreased to \$52.3 million for the three months ended June 30, 2009 from \$59.2 million for the three months ended June 30, 2008. Revenue decreased to \$104.1 million for the six months ended June 30, 2009 from \$111.7 million for the six months ended June 30, 2008. The decrease in the second quarter of 2009 compared to 2008 and for the six months of 2009 compared to 2008 was attributable to a slowdown in hospital capital spending and unfavorable foreign exchange rate fluctuations of 4% for the quarter and 6% for year to date.

U.S. revenue decreased to \$23.9 million for the three months ended June 30, 2009 from \$28.3 million for the three months ended June 30, 2008. U.S. revenue decreased to \$47.1 million for the six months ended June 30, 2009 from \$50.4 million for the six months ended June 30, 2008. The decrease in the second quarter 2009 compared to 2008 and for the six months of 2009 compared to 2008 was primarily attributable to a 20% decline in direct hospital sales during the quarter and a 17% decline year to date due to reduced hospital capital spending within the difficult economic environment.

Revenue from Europe, Africa and the Middle East decreased to \$14.1 million for the three months ended June 30, 2009 from \$15.7 million for the three months ended June 30, 2008. Revenue from Europe, Africa and the Middle East decreased to \$28.3 million for the six months ended June 30, 2009 from \$33.2 million for the six months ended June 30, 2008. These decreases were primarily due to an unfavorable foreign exchange impact of 10% for the quarter and 15% for year to date.

Revenue from Latin America and Canada decreased to \$5.3 million for the three months ended June 30, 2009 from \$5.5 million for the three months ended June 30, 2008. Revenue from Latin America and Canada decreased to \$10.0 million for the six months ended June 30, 2009 from \$11.4 million for the six months ended June 30, 2008. The decrease in the second quarter 2009 compared to 2008 was primarily due to decreased sales in Canada as well as an unfavorable exchange impact of 5% for the three months ended June 30, 2009, partially offset by an increase in Latin America. The decrease for the six months of 2009 compared to 2008 was primarily due to decreased sales in Latin America and Canada as well as an unfavorable foreign exchange impact of 7% for year to date.

Revenue from Asia Pacific decreased to \$9.0 million for the three months ended June 30, 2009 from \$9.8 million for the three months ended June 30, 2008. Revenue from Asia Pacific increased to \$18.6 million for the six months ended June 30, 2009 from \$16.8 million for the six months ended June 30, 2008. The decrease in the three months was primarily due to decreased sales in Japan as well as an unfavorable exchange rate of 6% for the three months ended June 30, 2009. The increase in the six months was primarily due to increased sales in Asia, partially offset by an unfavorable foreign exchange rate of 6% for year to date.

#### Fiscal Year 2009 Outlook

Given current economic conditions and foreign currency trends, we anticipate that revenue could potentially decrease by 5 to 10% in 2009 compared to 2008. We have introduced and plan to introduce additional new products and features, to develop the U.S. physicians' office market, and to expand our international operations. The expansion of our international markets, as well as the development of the U.S. hospital and physician office markets, considering current economic conditions, may not be as successful as anticipated and we may encounter regulatory and other issues in selling our products. Our revenue has been significantly and may be further impacted by fluctuations in foreign exchange rates in the countries in which we sell our products. Increased competition may also impact our anticipated growth in revenue. We currently face competition from larger companies that manufacture cart-based and

portable ultrasound systems and have greater financial and other resources.

## Gross margin

Gross margin was 71% for the three months ended June 30, 2009 and 70% for the three months ended June 30, 2008. The gross margin increased over the prior year quarter as a result of a decrease in inventory obsolescence charges and a reduction in material costs of 2%, offset by a foreign currency impact of 1%. Gross margin was 69% for the six months ended June 30, 2009 and 71% for the six months ended June 30, 2008. The gross margin decreased over the prior year as a result of foreign currency impact of approximately 2%, which was partially offset by a reduction in material costs.

## Fiscal Year 2009 Outlook

Increased competition from existing and new competitors as well as pricing pressure due to economic conditions could result in lower average realized prices and could lower our gross margin. Our gross margin can be expected to fluctuate in future periods based on the mix of business between direct, government and distributor sales; mix of U.S. and international sales; and our product and accessories sales mixes. Changes in our cost of inventory also may impact our gross margin. Adjustments to reduce carrying costs are recorded for obsolete material, earlier generation products and used or refurbished products held either as saleable inventory or as demonstration product. If market conditions change or 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 value of our inventory, resulting in a negative impact on gross margins. We rely on our sales forecasts by product to determine production volume. To the extent our sales forecasts or product mix estimates are inaccurate, we may produce excess inventory or experience inventory shortages, which may result in an increase in our costs of revenue, a decrease in our gross margin or lost sales. Our gross margin may also be impacted by fluctuations in foreign exchange rates.

## Operating expenses

Research and development expenses were \$7.4 million for the three months ended June 30, 2009, compared to \$6.9 million for the three months ended June 30, 2008. Research and development expenses were \$15.1 million for the six months ended June 30, 2009, compared to \$13.1 million for the six months ended June 30, 2008. The increases in both the three and six months were primarily attributable to increased headcount and other costs related to development of new features and products.

Sales, general and administrative expenses were \$27.6 million for the three months ended June 30, 2009, compared to \$29.2 million for the three months ended June 30, 2008. Sales, general and administrative expenses were \$53.4 million for the six months ended June 30, 2009, compared to \$58.5 million for the six months ended June 30, 2008. The decrease in both the three and six months was primarily attributable to a decrease in legal costs, a reduction in compensation expense, and foreign exchange rates.

In July 2008, we entered an agreement with Zonare Medical Systems, Inc. ("Zonare") to settle all pending claims. Under the Settlement Agreement, the parties agreed to dismiss all pending claims between the parties in consideration for cross-licenses of certain patents between the parties and a \$3.3 million payment from Zonare to SonoSite. The consideration was originally valued at \$0.3 million; however, consideration received amounted to \$1.2 million. The gain recorded on the transaction of \$0.9 million has been included within operating expenses.

## Fiscal Year 2009 Outlook

We anticipate that operating expenses will decrease in 2009 compared to 2008 through effective cost management.

## Other loss



Total other loss was \$2.3 million for the three months ended June 30, 2009 compared to \$2.9 million for the three months ended June 30, 2008. Total other loss was \$2.5 million for the six months ended June 30, 2009 compared to \$4.9 million for the six months ended June 30, 2008. The decrease in loss was primarily attributable to the gain recognized on the repurchase of our convertible senior notes and lower interest expense as a result of less outstanding debt compared to the prior year; partially offset by lower interest income on our investment balances resulting from lower interest rates. Amounts reported in comparable prior periods have been restated 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.

## Fiscal Year 2009 Outlook

We anticipate that we will incur losses in 2009 primarily due to the additional interest expense resulting from the adoption of APB 14-1, lower interest income due to lower interest rates, and lower gains as we do not expect to repurchase the same amount of convertible senior notes.

## Income tax expense

Income tax provision was \$0.3 million for the three months ended June 30, 2009, compared to \$1.0 million for the three months ended June 30, 2008. Income tax provision was \$0.8 million for the six months ended June 30, 2009, compared to \$1.2 million for the six months ended June 30, 2008. 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. Amounts reported in comparable prior periods have been restated due to the adoption of APB 14-1.

## Fiscal Year 2009 Outlook

We anticipate that our annual consolidated effective tax rate will approximate 39% for fiscal year 2009.

## Warranty expense

We expect our warranty liability and expense to continue to increase due to the five-year warranty offered with the MicroMaxx system, M-Turbo system and S Series ultrasound tools as our installed base increases. Should actual failure rates or repair or replacement costs for any of our products differ from estimates, revisions to the estimated warranty liability may be required and our results may be materially affected.

## Liquidity and Capital Resources

Our cash and cash equivalents balance was \$193.9 million as of June 30, 2009, compared to \$209.3 million as of December 31, 2008. Cash and cash equivalents were primarily invested in money market accounts. Our short-term and long-term investment securities totaled \$69.5 million as of June 30, 2009, compared to \$70.5 million as of December 31, 2008. Investment securities generally 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.

As of June 30, 2009, we had \$1.8 million in the Columbia Strategic Cash Portfolio, which is in the process of liquidation. Distributions from this portfolio are solely at the discretion of the portfolio manager. We have recorded \$1.3 million as a short-term investment and \$0.5 million as a long-term investment.

Operating activities provided cash of \$7.4 million for the six months ended June 30, 2009, compared to cash provided of \$5.0 million for the six months ended June 30, 2008. Net income for the six months ended June 30, 2009 was adjusted by stock-based compensation expense of \$3.9 million, depreciation and amortization of \$2.1 million, amortization of debt discount and debt issuance costs of \$2.6 million, and deferred income taxes of \$0.9 million. Operating assets and liabilities were primarily impacted by the timing of payments and receipts. For the six month period ended June 30, 2009 operating assets provided \$11.6 million and operating liabilities used \$12.9 million. The change in operating assets is due to accounts receivable collections being higher than sales for 2009 compared to 2008, and the change in operating liabilities is due to the timing of payments of accounts payable and accrued expenses.

Investing activities used cash of \$1.1 million for the six months ended June 30, 2009, compared to cash used of \$13.8 million for the six months ended June 30, 2008. The cash used in 2009 was primarily due to the purchase of investment securities of \$67.8 million, the purchase of property and equipment of \$1.8 million, and \$0.4 million of earn-out consideration associated with the acquisition of SonoMetric Health, Inc, offset by proceeds from the sale and maturity of investments of \$68.8 million.

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Financing activities used cash of \$19.9 million for the six months ended June 30, 2009, compared to cash provided of \$2.8 million for the six months ended June 30, 2008. Cash used in financing activities was primarily due to the repurchase of our convertible debt and associated warrants for \$21.8 million partially offset by the sale of call options for \$1.4 million and proceeds from the exercise of stock options and employee stock purchase plan totaling \$1.4 million.

We believe that our existing cash and cash generated from operations will be sufficient to fund our operations and anticipated acquisition of CardioDynamics, capital expenditures and repurchases of convertible debt in 2009. Nevertheless, we may experience an increased need for additional cash due to:

- any significant decline in our revenue or gross margin;
- any delay or inability to collect accounts receivable;
- any acquisition or strategic investment in another business;
- any significant increase in expenditures as a result of expansion of our sales and marketing infrastructure, our manufacturing capability or our product development activities; and
- any significant increase in our sales and marketing expenditures as a result of our introduction of new products.

#### Risk Factors

A complete listing of our risk factors is contained in the Item 1A. "Risk Factors" section of our Annual Report on Form 10-K for the year ended December 31, 2008.

#### Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with instructions for Form 10-Q and Article 10 of Regulation S-X. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to product returns, bad debts, inventories, investments, warranty obligations, service contracts, incentive compensation, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. The results form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

As discussed in Item 7, "Management Discussion and Analysis of Financial Condition and Results of Operations" of our annual report on Form 10-K for the year ended December 31, 2008, our critical accounting policies and estimates include revenue recognition, investments, valuation of inventories, warranty expense, income taxes, stock-based compensation, convertible debt and hedge transaction and acquisitions.

Long term debt. On 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. We bifurcated a component of the conversion option and classified that component in equity. The value of the equity component was calculated by first measuring the fair value of the liability component, using the discount rate of a similar liability that does not have a conversion feature, as of the issuance date. The difference between the proceeds for the convertible debt and the amount reflected as the liability component was recorded as the equity component. We recognize the accretion of the resulting discount as part of interest expense in our consolidated statement of income.

Upon settlement of our Notes, we revalue the liability component, utilizing an interest rate of comparable nonconvertible debt. We allocate a portion of the consideration transferred to the liability component equal to the fair

value of that component immediately prior to repurchase. Any difference between the consideration attributed to the liability component and the sum of the net carrying amount of the liability component and unamortized debt issuance costs is recognized as a gain or loss in the statement of income. Any remaining consideration is allocated to the reacquisition of the equity component and is recognized as a reduction of stockholders' equity.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest rate 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.

As of June 30, 2009, our investment portfolio consisted of \$67.7 million of interest-bearing debt securities with maturities of less than one year. Generally we have the ability to hold these securities until maturity; however, we have classified them as available-for-sale in the event of 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 2008 from a hypothetical 10% increase in market interest rates would not have a material impact on the investment portfolio.

As of June 30, 2009, we also had \$1.8 million 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. We have recorded \$1.3 million as a short-term investment and \$0.5 million as a long-term investment based on the expected liquidation schedule.

Foreign currency risk

Except for sales transacted by our wholly-owned subsidiaries, we transact substantially all our sales in USDs; therefore, the obligations of many of our international customers are in USDs. Our exposure to risk from fluctuations in foreign currencies relates to revenues and expenses transacted by subsidiaries in foreign currencies. Additionally, we have exposure related to the strengthening of the USD against the local currency of our international subsidiaries, which may result in foreign exchange losses on transactions with them, and our international customers, which may impact our sales to our customers and our ability to collect amounts owed by them.

As of June 30, 2009, 72% of our outstanding accounts receivable balance was from international customers, of which 40%, or \$12.5 million, was denominated in a currency other than USDs. Total sales for the three months ended June 30, 2009 denominated in a currency other than USDs were \$18.4 million, or 35% of total consolidated revenues. Total sales for the six months ended June 30, 2009 denominated in a currency other than USDs were \$38.0 million, or 37% of total consolidated revenues. The British pound, the Euro and the Japanese yen represented the majority of financial transactions executed in a foreign currency. We regularly review our foreign currency accounts receivable positions for any indication that collection may be at risk. In addition, we utilize letters of credit where they are warranted in order to mitigate our collection risk.

We periodically enter into foreign currency forward and participating forward contracts to reduce the impact of adverse fluctuations on earnings associated with foreign currency exchange rate changes. As of June 30, 2009, we had \$43.6 million in notional amount of foreign currency forward contracts that expire on July 31, 2009. They serve as hedges of a substantial portion of our intercompany balances denominated in a currency other than the USD. These foreign currencies primarily include the British pound, the Euro and the Japanese yen. A sensitivity analysis of a change in the fair value of these contracts indicates that if the USD weakened by 10% against the applicable foreign currency, the fair value of these contracts would decrease by approximately \$5.0 million. Conversely, if the USD strengthened by 10% against the applicable foreign currency, the fair value of these contracts would increase by approximately \$5.0 million. Gains and losses in the fair value of these contracts are intended to offset the losses and gains on the underlying intercompany balances. These offsetting gains and losses are not reflected in the sensitivity analysis above. The fair value of these contracts as of June 30, 2009 was not material to our results of operations or our financial position.

During the second quarter of 2009, we began using foreign currency forward contracts to hedge the impact of currency fluctuations on the translation of the financial statements of our foreign operations. As of June 30, 2009, we had \$6.8 million in notional amount of foreign currency forward contracts expiring at various dates through December 31, 2009. These derivatives are not eligible for hedge accounting treatment and changes in the fair value of these derivatives are recorded in other income on the consolidated statement of income. For the three months and six months ended June 30, 2009, we recognized a mark to market loss on these contracts of \$38,000.

## Current Credit and Financial Markets

The recent worldwide financial and credit crisis has reduced the availability of liquidity and credit for our customers to fund the continuation and expansion of their business operations. The shortage of liquidity and credit combined with recent substantial losses in worldwide equity markets could lead to an extended worldwide economic recession. This trend could adversely affect our customers' ability to commit to capital spending or to pay and could lead to pressure to reduce prices for our products and could cause a decrease in the size of the market and adversely affect our revenue and profitability, which could harm our business. Our revenues may be impacted by our customers' ability to finance the purchase of our systems and cost control efforts implemented by our customers. We have observed indications of an economic slowdown, which appears to be impacting U.S. hospital purchase behavior. Based on our analysis, economic conditions may continue to drive delays in orders. Increased competition may also impact our anticipated growth in revenue.

## Item 4. Controls and Procedures

### Evaluation of disclosure controls and procedures

As of June 30, 2009, our chief executive officer and our chief financial officer have evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15 e) and 15d-15 e) of the Securities Exchange Act of 1934 (the Exchange Act), and they have concluded that our disclosure controls and procedures were effective to ensure that the information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

### Changes in internal control over financial reporting

We continue to review, revise and improve the effectiveness of our internal controls. There have been no changes in the Company's internal controls over financial reporting during the second quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II: OTHER INFORMATION

### Item 1. Legal Proceedings

On May 15, 2007, GE Healthcare ("GE") filed a lawsuit against us in the federal district court in the Western District of Wisconsin. The lawsuit alleged that certain of our products willfully infringed certain of GE's U.S. patents relating to ultrasound technology. We filed a counterclaim against GE and certain of its affiliates, and filed an answer denying all of GE's claims and alleging that the asserted patents are either invalid, not infringed, or both. In rulings issued on July 24, 2008, the trial judge granted summary judgment motions in our favor on five of the six patents that GE had asserted against us. The court ruled that one of the GE patents is invalid and that our products do not infringe the other four GE patents. The trial judge also granted summary judgment in GE's favor on two of our four asserted patents finding that GE's accused products did not infringe our asserted patents. On July 28, 2008 the parties filed a stipulation for dismissal without prejudice for the remaining claims and counterclaims for the three remaining patents that have yet to be ruled on by summary judgment in this case, thereby negating the need for a trial. On July 31, 2008, the court granted the parties' request for dismissal of the remaining claims and counterclaims that had not been ruled on by the judge. The parties have appealed certain of the trial court's summary judgment decisions and other rulings to the Court of Appeals for the Federal Circuit. Oral argument at the Federal Circuit took place in early July. We expect an appellate decision later this year.



On May 22, 2008, GE filed a second suit in the same federal court in Wisconsin seeking to invalidate our U.S. patent 5,722,412. We have counterclaimed that the new ultrasound systems GE proposes to market and sell infringe this patent. The trial was held in early June 2009 and post trial briefing took place during the month of July. We expect a decision to be issued later this year.

Item 6. Exhibits

Exhibit No.	Description
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350 Section 906 of the Sarbanes-Oxley Act of 2002)
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350 Section 906 of the Sarbanes-Oxley Act of 2002)

SIGNATURE

Pursuant to the requirements of Section 13 or 15 d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SONOSITE, INC.  
(Registrant)

Dated: August 3, 2009

By: /s/ MICHAEL J. SCHUH

Michael J. Schuh  
Vice President, Chief Financial Officer  
and Treasurer  
Authorized Officer and Principal  
Financial Officer)

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