

SONOSITE INC  
Form 10-Q  
November 09, 2009  
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# SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the quarterly period ended September 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)

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**Washington**  
**(State or Other Jurisdiction of**  
**Incorporation or Organization)**

**21919 30th Drive SE, Bothell, WA**  
**(Address of Principal Executive Offices)**

**(425) 951-1200**

**(Registrant's Telephone Number, Including Area Code)**

**91-1405022**  
**(I.R.S. Employer**  
**Identification Number)**

**98021-3904**  
**(Zip 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  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

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

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)**

**17,347,491**  
**(Outstanding as of October 29, 2009)**

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**SonoSite, Inc.**

**Quarterly Report on Form 10-Q**

**For the Quarter Ended September 30, 2009**

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**Table of Contents****PART I: FINANCIAL INFORMATION****Item 1. Financial Statements****SonoSite, Inc.****Condensed Consolidated Balance Sheets****(unaudited)**

(In thousands, except share data)	September 30, 2009	December 31, 2008 As Adjusted
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 211,035	\$ 209,258
Short-term investment securities	36,864	69,882
Accounts receivable, less allowances of \$1,889 and \$2,190	55,414	66,094
Inventories	35,309	29,115
Deferred income taxes, current	14,830	13,372
Prepaid expenses and other current assets	6,695	6,623
<b>Total current assets</b>	<b>360,147</b>	<b>394,344</b>
Property and equipment, net	9,393	8,955
Investment securities		578
Goodwill	3,902	3,767
Deferred income taxes	180	793
Identifiable intangible assets, net	24,939	13,062
Other assets	3,595	5,383
<b>Total assets</b>	<b>\$ 402,156</b>	<b>\$ 426,882</b>
<b>Liabilities and Shareholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 8,451	\$ 6,189
Accrued expenses	21,616	31,921
Deferred revenue, current portion	2,485	2,755
<b>Total current liabilities</b>	<b>32,552</b>	<b>40,865</b>
Long-term debt, net	95,717	111,336
Deferred tax liability, net	6,776	9,871
Other non-current liabilities	14,168	13,750
<b>Total liabilities</b>	<b>149,213</b>	<b>175,822</b>
<b>Commitments and contingencies</b>		
Shareholders' equity:		
Preferred stock, \$1.00 par value		
Authorized shares 6,000,000		
Issued and outstanding shares none		

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Common stock, \$.01 par value		
Authorized shares	50,000,000	
Issued and outstanding shares:		
As of September 30, 2009	17,327,204	173
As of December 31, 2008	17,054,697	171
Additional paid-in-capital	289,661	285,757
Accumulated deficit	(34,988)	(36,036)
Accumulated other comprehensive (loss) income	(1,903)	1,168
Total shareholders' equity	252,943	251,060
Total liabilities and shareholders' equity	\$ 402,156	\$ 426,882

See accompanying notes to condensed consolidated financial statements.

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

(In thousands, except net (loss) income per share)	Three Months Ended September 30, 2008		Nine Months Ended September 30, 2008	
	2009	As Adjusted	2009	As Adjusted
Revenue	\$ 53,571	\$ 61,633	\$ 157,661	\$ 173,362
Cost of revenue	16,021	18,562	48,033	50,962
Gross margin	37,550	43,071	109,628	122,400
Operating expenses:				
Research and development	6,497	7,440	21,569	20,574
Sales, general and administrative	28,874	28,254	81,682	86,712
Licensing income and litigation settlement		(2,643)	(924)	(2,643)
Acquisition costs, net of bargain purchase (gain)	(110)		469	
Total operating expenses	35,261	33,051	102,796	104,643
Other income (loss)				
Interest income	369	2,188	1,906	7,142
Interest expense	(2,623)	(4,327)	(7,567)	(12,891)
Other	(759)	(1,516)	175	(2,842)
Total other loss, net	(3,013)	(3,655)	(5,486)	(8,591)
(Loss) Income before income taxes	(724)	6,365	1,346	9,166
Income tax (benefit) provision	(484)	2,715	298	3,914
Net (loss) income	\$ (240)	\$ 3,650	\$ 1,048	\$ 5,252
Net (loss) income per share:				
Basic	\$ (0.01)	\$ 0.22	\$ 0.06	\$ 0.31
Diluted	\$ (0.01)	\$ 0.21	\$ 0.06	\$ 0.30
Weighted average common and potential common shares outstanding:				
Basic	17,308	16,927	17,203	16,858
Diluted	17,308	17,592	17,650	17,488

See accompanying notes to condensed consolidated financial statements.

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

<b>(In thousands)</b>	<b>Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008 As Adjusted</b>
<b>Operating activities:</b>		
Net income	\$ 1,048	\$ 5,252
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,647	3,086
Stock-based compensation	5,201	5,209
Deferred income tax provision	1,216	2,528
Amortization of net discounts on investment securities	(284)	(443)
Amortization of debt discount and debt issuance costs	3,792	6,581
Accretion of contingent purchase consideration	720	675
Excess tax benefit from exercise of stock based awards		(961)
Net loss on investments and derivatives	123	225
Gain on convertible note repurchase	(1,339)	
Non-cash gain on litigation settlement		(643)
Loss on disposal of property and equipment	31	
Gain on bargain purchase of CardioDynamics	(1,078)	
Changes in operating assets and liabilities:		
Accounts receivable	13,352	2,513
Inventories	(2,868)	63
Prepaid expenses and other assets	1,108	(4,836)
Accounts payable	(135)	64
Accrued expenses	(14,276)	(591)
Deferred liabilities	(1,347)	(724)
<b>Net cash provided by operating activities</b>	<b>8,911</b>	<b>17,998</b>
<b>Investing activities:</b>		
Purchases of investment securities	(100,338)	(182,608)
Proceeds from sales/maturities of investment securities	134,277	244,976
Purchases of property and equipment	(2,290)	(2,198)
Acquisition of CardioDynamics, net of cash acquired	(8,185)	
Earn-out consideration associated with SonoMetric acquisition	(387)	(921)
<b>Net cash provided by investing activities</b>	<b>23,077</b>	<b>59,249</b>
<b>Financing activities:</b>		
Excess tax benefit from stock-based awards		961
Minimum tax withholdings on stock-based awards	(1,285)	
Proceeds from exercise of stock-based awards	1,419	3,526
Retirement of convertible debt	(25,750)	
Proceeds from sale of call options	1,409	
Repurchase of warrants	(1,325)	
<b>Net cash (used in) provided by financing activities</b>	<b>(25,532)</b>	<b>4,487</b>
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<b>(4,679)</b>	<b>1,262</b>

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Net change in cash and cash equivalents	1,777	82,996
Cash and cash equivalents at beginning of period	209,258	188,701
Cash and cash equivalents at end of period	\$ 211,035	\$ 271,697
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$ 2,520	\$ 2,048
Cash paid for interest	\$ 5,202	\$ 8,414

See accompanying notes to condensed consolidated financial statements.



**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements****(unaudited)****Interim Financial Information****1. Summary of Significant Accounting Policies*****Basis of Presentation***

The information contained herein has been prepared in accordance with instructions for Form 10-Q and Article 10 of Regulation S-X. The information reflects, in the opinion of SonoSite, Inc. management, all adjustments necessary (which are of a normal and recurring nature) for a fair presentation of the results for the interim periods presented. The results of operations for the three and nine months ended September 30, 2009, including CardioDynamics International Corporation's (CDIC) results of operations from August 14, 2009 to September 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 (FASB) Accounting Standards Codification (ASC) Topic 470, subtopic 20 (470-20), formerly Financial Accounting Standards Board Staff Position No. APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement), on January 1, 2009. For additional detail on the adjusted balances, refer to the Note 5.

***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):

	<b>September 30, 2009</b>	<b>As of December 31, 2008</b>
Raw material	\$ 13,093	\$ 10,007
Demonstration inventory	9,570	8,198
Finished goods	12,646	10,910
Total	\$ 35,309	\$ 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 and with our newly acquired BioZ Dx impedance cardiography system.



**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)**

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

	<b>Beginning of Period</b>	<b>Charged To Cost of Revenue</b>	<b>Applied to Liability</b>	<b>Liability Acquired</b>	<b>End of Period</b>
Three months ended September 30, 2009	\$ 7,900	\$ 1,208	\$ (708)	\$ 301	\$ 8,701
Three months ended September 30, 2008	\$ 5,093	\$ 1,402	\$ (473)	\$	\$ 6,022
Nine months ended September 30, 2009	\$ 7,094	\$ 3,245	\$ (1,939)	\$ 301	\$ 8,701
Nine months ended September 30, 2008	\$ 4,045	\$ 3,239	\$ (1,262)	\$	\$ 6,022

**Income taxes**

The income tax provisions for the three and nine months ended September 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 increase in our consolidated effective tax rate for the three months ended September 30, 2009 resulted from a low level of book income relative to permanent differences related to the research and development tax credit and domestic production activities tax deduction. The decrease in our consolidated effective tax rate for the nine months ended September 30, 2009, as compared to 2008, results primarily from the reinstatement of the U.S. research and development tax credit in the fourth quarter of 2008 and our qualification for the domestic production activities tax deduction.

**Net (loss) income per share**

Basic net (loss) income per share is based on the weighted average number of common shares outstanding during the period. Diluted net (loss) 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 (loss) 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 (loss) income per share.

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

	<b>Three Months Ended September 30, 2008</b>		<b>Nine Months Ended September 30, 2008</b>	
	<b>2009</b>	<b>As Adjusted</b>	<b>2009</b>	<b>As Adjusted</b>
Net (loss) income	\$ (240)	\$ 3,650	\$ 1,048	\$ 5,252
Weighted average common shares outstanding used in computing basic net (loss) income per share	17,308	16,927	17,203	16,858
Effect of dilutive stock options and restricted stock units		665	447	630
	17,308	17,592	17,650	17,488

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Weighted average common shares outstanding used in computing diluted net (loss)  
income per share

Net (loss) income per share:				
Basic	\$ (0.01)	\$ 0.22	\$ 0.06	\$ 0.31
Diluted	\$ (0.01)	\$ 0.21	\$ 0.06	\$ 0.30

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)**

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2009	2008	2009	2008
Stock options and restricted stock units	1,300	575	1,379	692
Warrants outstanding	1,184	2,500	1,184	2,500
<b>Total common shares excluded from diluted net (loss) income per share</b>	<b>2,484</b>	<b>3,075</b>	<b>2,563</b>	<b>3,192</b>

The computation of diluted net (loss) 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 be 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 (loss) 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 (loss) income.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2009	2008	2009	2008
		As Adjusted		As Adjusted
Net (loss) income	\$ (240)	\$ 3,650	\$ 1,048	\$ 5,252
Other comprehensive loss:				
Foreign currency translation adjustments	(1,592)	(447)	(2,874)	(126)
Unrealized losses arising during the period	(94)	(147)	(197)	(133)
<b>Comprehensive (loss) income</b>	<b>\$ (1,926)</b>	<b>\$ 3,056</b>	<b>\$ (2,023)</b>	<b>\$ 4,993</b>

***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 arising as a result of defects in the design or manufacture of our products or as the result of willful misconduct of our employees; (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. Prior to the acquisition, CDIC had provided a reimbursement guarantee to certain customers that Medicare reimbursement would not be rescinded. These guarantees expire over the next five years.

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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.

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****2. Cash, cash equivalents and investment securities**

Effective April 1, 2009, we adopted ASC 320-10-65-1, Transition Related to 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):

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
Cash	\$ 15,617	\$ 13,921
Cash equivalents:		
Corporate debt securities	22,294	59,947
Other debt obligations	173,124	135,390
<b>Total cash and cash equivalents</b>	<b>\$ 211,035</b>	<b>\$ 209,258</b>
Investment securities:		
Short-term	\$ 36,864	\$ 69,882
Long-term	\$	\$ 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, certificates of deposit, 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 September 30, 2009, our investment in the Columbia Strategic Cash Portfolio has been liquidated. As of December 31, 2008, we had an investment of \$2.8 million invested in this portfolio. Distributions from this portfolio were solely at the discretion of the portfolio manager. This investment had been measured at fair value, which was 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. All other investment securities will mature by the end of the first quarter of 2010.

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)**

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
<b>As of September 30, 2009:</b>				
Cash equivalents:				
Corporate debt securities	\$ 22,286	\$ 8	\$	\$ 22,294
Other debt securities	173,124			173,124
<b>Total cash equivalents</b>	<b>\$ 195,410</b>	<b>\$ 8</b>	<b>\$</b>	<b>\$ 195,418</b>
Short-term:				
Corporate debt securities	\$ 32,281	\$ 25	\$	\$ 32,306
Other debt securities	4,558			4,558
<b>Total short-term investments</b>	<b>\$ 36,839</b>	<b>\$ 25</b>	<b>\$</b>	<b>\$ 36,864</b>
<b>As of December 31, 2008:</b>				
Cash equivalents:				
Corporate debt securities	\$ 59,829	\$ 118	\$	\$ 59,947
Other debt securities	135,390			135,390
<b>Total cash equivalents</b>	<b>\$ 195,219</b>	<b>\$ 118</b>	<b>\$</b>	<b>\$ 195,337</b>
Short-term:				
Corporate debt securities	\$ 67,129	\$ 234	\$	\$ 67,363
Other debt securities	2,521		(2)	2,519
<b>Total short-term investments</b>	<b>\$ 69,650</b>	<b>\$ 234</b>	<b>\$ (2)</b>	<b>\$ 69,882</b>
Long-term:				
Other debt securities	\$ 578	\$	\$	\$ 578
<b>Total long-term investments</b>	<b>\$ 578</b>	<b>\$</b>	<b>\$</b>	<b>\$ 578</b>

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

**Three Months Ended  
September 30,**

**Nine Months Ended  
September 30,**



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	2009	2008	2009	2008
Gains	\$ 117	\$	\$ 130	\$ 8
Losses		(3)		(8)
Realized gain (loss), net	\$ 117	\$ (3)	\$ 130	\$

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

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

	September 30, 2009	As of December 31, 2008
Gains	\$ 33	\$ 350
Losses		
Unrealized gains, net	\$ 33	\$ 350

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****3. Fair value measurements**

The following table provides the Level 1 financial assets and liabilities that were measured at fair value as of September 30, 2009 (in thousands):

	Fair Value Measurements	
	Total Carrying Value	Quoted Prices in Active Markets (Level 1)
Investment Securities		
Corporate debt securities	\$ 32,306	\$ 32,306
Other debt obligations	4,558	4,558
Total investment securities	\$ 36,864	\$ 36,864
Foreign currency hedges	\$ 340	\$ 340
Long-term debt, net	\$ 95,717	\$ 116,560

Investment securities and foreign currency hedges are measured at fair value using quoted market prices. Long-term debt is measured at fair value for disclosure only using quoted market prices. There were no changes to the valuation techniques during the three and nine months ended September 30, 2009. The carrying value of long-term debt was reduced as the result of the adoption of ASC 470-20. See Note 5 for additional information.

Our investment in the Columbia Strategic Cash Portfolio, which has been liquidated, was previously our only Level 3 investment. The following table summarizes activity of our Level 3 investments (in thousands):

**Fair value measurements of Significant Unobservable Inputs (Level 3) investments**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Balance, at beginning of period	\$ 1,811	\$ 6,460	\$ 2,765	\$ 12,574
Total gain (loss) (realized or unrealized) included in:				
Other income (loss)	117	(49)	125	(225)
Other comprehensive loss	(97)	(27)		
Distributions	(1,831)	(1,898)	(2,890)	(7,863)
Balance, at end of period	\$	\$ 4,486	\$	\$ 4,486
Gains (losses) included in other income (loss) attributable to the change in unrealized losses relating to assets still held	\$	\$ (43)	\$	\$ (142)

We perform impairment tests on certain assets, including goodwill and intangible assets at fair value on a recurring 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

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September 30, 2009, there were no impairments recorded for goodwill and intangible assets.

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****4. Acquisition**

On August 14, 2009, we acquired all of the outstanding stock of CDIC, a leader in impedance cardiography ( ICG ) for noninvasive hemodynamic assessment that develops, manufactures, and markets ICG devices and sensors. The ICG product line provides non-invasive assessment of cardiac output and other hemodynamic parameters. The business combination enables us to expand our distribution platform and product offerings.

Concurrently with this acquisition, we obtained full control of Medis Medizinische Messtechnik GmbH ( Medis ), which develops, manufactures, and markets ICG diagnostic and monitoring devices. CDIC had previously owned 80% of Medis, based in Germany.

Cash consideration of \$10.7 million was transferred for the shares of CDIC and Medis. Operating expenses include acquisition related charges of \$1.0 million in the third quarter and \$1.5 million for the nine months ended of 2009, reduced by a bargain purchase gain of \$1.1 million.

The following table summarizes the acquisition-date fair value of the assets acquired and the liabilities assumed in connection with the business combination (in thousands):

	<b>August 14, 2009</b>
<b>Assets</b>	
Current assets:	
Cash and cash equivalents	\$ 2,511
Accounts receivable	2,560
Inventories	2,799
Deferred income taxes	5,376
Prepaid expenses and other current assets	95
Total current assets	13,341
Property and equipment, net	1,001
Identifiable intangible assets	12,400
Other assets	158
Total assets	\$ 26,900
<b>Liabilities</b>	
Current liabilities:	
Accounts payable	\$ 2,459
Accrued expenses and other current liabilities	2,191
Total current liabilities	4,650
Long-term debt	5,500
Deferred tax liability	4,538
Other non-current liabilities	437
Total liabilities	\$ 15,125

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Net assets acquired	\$ 11,775
Acquisition consideration	\$ 10,697
Gain on bargain purchase	\$ 1,078

These assets and liabilities were Level 3 measurements recorded at the acquisition-date fair value. We used an income approach, which is a measurement of the present value of the net economic benefit or cost expected to be derived from an asset or liability, to measure the acquired assets and liabilities excluding inventory, internally developed software, and property and equipment. Inventory and internally developed software were measured using a cost approach. Property and equipment were valued using a combination of the market and cost approaches.

Due to the timing of the acquisition, certain items including income taxes and third-party valuations reports are expected to be finalized in the fourth quarter of 2009. We do not expect material changes resulting from finalization of these pending items.

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)**

Intangible assets acquired consisted of the following (in thousands):

	<b>Amount</b>	<b>Amortization Period ( in years)</b>
Developed technology	\$ 1,500	5.0
Customer relationships	9,300	4.8
Trademarks	800	2
Internally developed software	800	3
<b>Total intangibles</b>	<b>\$ 12,400</b>	<b>4.5</b>

The total fair value of short-term and long-term receivables acquired amounted to \$2.7 million. The contractual amount due on these receivables is \$3.8 million, of which a reduction of \$1.1 million has been taken for credit risk.

We recognized a warranty liability of \$0.3 million related to CDIC's products. We expect to incur the majority of these costs by the end of 2011. The potential undiscounted amount of all future payments that we could be required to make under the warranty arrangements is estimated to be \$0.3 million. As of September 30, 2009, there has been no change since August 14, 2009, in the amount recognized for this liability or any change in the range of outcomes or assumptions used to develop the estimates.

We recognized a deferred tax asset of \$5.4 million, which includes \$3.9 million related to CDIC's federal net operating loss ( NOL ) carryforward. CDIC had federal NOL carryforwards of \$52.6 million based on tax returns filed through November 30, 2008 which will be available to offset our future taxable income until they expire between 2010 and 2028. The NOL carryforward that will be available for utilization during this period is limited to \$11.1 million, resulting from change in ownership limitations under Section 382 of the Internal Revenue Code. CDIC had state NOL carryforwards of \$1.1 million against which we have recorded a full valuation allowance given the uncertainty as to whether we will have sufficient income in these states in the future to utilize these NOLs. We recognized an additional \$1.5 million deferred tax asset and a \$4.5 million deferred tax liability related to the difference in the book and tax bases of acquired assets and liabilities.

When there is a gain on a bargain purchase, accounting standards require a reassessment to determine all assets acquired, liabilities assumed, and consideration transferred. We have performed a reassessment and have still concluded that we have a gain on a bargain purchase. Because the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the excess of the value of the net assets acquired over the purchase price has been recorded as a gain on bargain purchase.

The results of CDIC's operations were included in our consolidated financial statements since the date of acquisition. The amount of CDIC's revenue and earnings included in our consolidated financial statements and the revenue and earnings of the combined entity had the acquisition date been January 1, 2009, or January 1, 2008 are as follows (in thousands):

	<b>Revenue</b>	<b>Earnings (Loss)</b>
<b>CDIC:</b>		
Actual from August 14, 2009 to September 30, 2009	\$ 2,962	\$ (304)
<b>Supplemental pro forma from the combined entity for the period:</b>		
January 1, 2009 to September 30, 2009	\$ 173,374	\$ (2,623)
January 1, 2008 to September 30, 2008	\$ 191,003	\$ 2,593

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Because CDIC's fiscal year ended in November, one month prior to our year-end, revenue and earnings (loss) in the pro forma disclosures have been adjusted to reflect our fiscal year. Additionally, CDIC earnings (loss) were adjusted to reflect the statutory tax rate utilized by SonoSite in the pro forma periods presented. Pro forma earnings (loss) exclude non-recurring charges including acquisition costs, and integration costs, and gain on bargain purchase, but include amortization of intangibles resulting from this acquisition.

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****5. Change in Accounting Principle**

Effective January 1, 2009, we adopted ASC 470-20, which clarifies the accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. ASC 470-20 required 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. ASC 470-20 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. ASC 470-20 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) is within the scope of ASC 470-20.

Upon issuance of the Notes and prior to the adoption of ASC 470-20, 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 ASC 470-20, 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, which were included in other assets in our consolidated balance sheet, were reclassified to equity on a proportionate basis as the equity component. The adoption of ASC 470-20 did not require any changes to the treatment of our call options and warrants that are classified as equity.

As a result of adopting ASC 470-20, the change in accounting principle had the following effect on prior year balances (in thousands except per share data):

	Three Months Ended September 30, 2008		Nine Months Ended September 30, 2008	
	As Adjusted	As Reported	As Adjusted	As Reported
<b>Selected Statement of Income Data</b>				
Operating income	\$ 10,020	\$ 10,020	\$ 17,757	\$ 17,757
Total other loss	(3,655)	(1,701)	(8,591)	(2,808)
Income before income taxes	6,365	8,319	9,166	14,949
Income tax provision	2,715	3,593	3,914	6,454
Net income	\$ 3,650	\$ 4,726	\$ 5,252	\$ 8,495
Net income per share:				
Basic	\$ 0.22	\$ 0.28	\$ 0.31	\$ 0.50
Diluted	\$ 0.21	\$ 0.27	\$ 0.30	\$ 0.49



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Shares used in computing net income per share:

Basic	16,927	16,927	16,858	16,858
Diluted	17,592	17,592	17,488	17,488

We recognized an additional \$2.0 million and \$5.8 million in interest expense for the three and nine months ended September 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 \$6.3 million for the three months and nine months ended September 30, 2008.

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)**

The adoption of ASC 470-20 also resulted in changes in our consolidated balance sheet for the year ended December 31, 2008 as follows (in thousands):

	Year Ended December 31, 2008	
	As Adjusted	As Reported
<b>Condensed Balance Sheet Data</b>		
Total current assets	\$ 394,344	\$ 390,327
Total non-current assets	32,538	38,960
Total assets	\$ 426,882	\$ 429,287
Total current liabilities	\$ 40,865	\$ 40,865
Total non-current liabilities	134,957	158,495
Total liabilities	175,822	199,360
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
Total liabilities and shareholders' equity	\$ 426,882	\$ 429,287

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.

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)**

The following table summarizes the impact of the adoption of ASC 470-20 on the affected balances within shareholders' equity (in thousands):

	<b>Additional paid-in capital(1)</b>	<b>Accumulated deficit</b>
Balance at December 31, 2007, as reported	\$ 236,158	\$ (44,893)
Adjustments for adoption of ASC 470-20 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)
<b>Balance at December 31, 2007, as adjusted</b>	<b>\$ 275,123</b>	<b>\$ (47,258)</b>
Balance at December 31, 2008, as reported	\$ 252,895	\$ (24,307)
Cumulative impact from 2007 adjustments	38,965	(2,365)
Adjustments for adoption of ASC 470-20 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)
<b>Balance at December 31, 2008, as adjusted</b>	<b>\$ 285,757</b>	<b>\$ (36,036)</b>

(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 ASC 470-20 (in thousands):

	<b>September 30, 2009</b>	<b>As of December 31, 2008</b>
Equity component	\$ 33,686	\$ 34,746
Senior convertible debt:		
Outstanding	\$ 119,745	\$ 144,745
Debt discount	24,283	33,409
<b>Convertible senior notes, net</b>	<b>\$ 95,462</b>	<b>\$ 111,336</b>

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

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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 September 30, 2009 and \$3.8 million year to date. Interest expense related to the contractual coupon was \$1.1 million and \$3.4 million for the three and nine months ended September 30, 2009.

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**SonoSite, Inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(unaudited)**

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 ASC 470-20. 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 ASC 470-20. Following the repurchases, debt issuance costs approximated \$2.7 million, or \$3.9 million prior to the adoption of ASC 470-20.

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.

Holders 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

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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.

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****6. Hedging activities**

On January 1, 2009, we adopted ASC 810-10-65-1, formerly 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 are the British pound, the European Union euro, the Japanese yen, the Australian dollar and the Canadian dollar.

We utilize foreign currency forward contracts to offset foreign currency risk associated with our intercompany balances denominated in a currency other than the US Dollar on our balance sheet. As of September 30, 2009, we had \$46.2 million in notional amount of foreign currency forward contracts expiring October 31, 2009. The fair value of these contracts as of September 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 September 30, 2009, we had \$7.3 million in notional amount of foreign currency forward contracts expiring at various dates through February 2010. These derivatives are not eligible for hedge accounting treatment. The fair value of these contracts as of September 30, 2009 has been disclosed in Note 3.

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
<b>Balance Sheet Hedges</b>				
(Loss) gain on foreign currency hedges	\$ (2,862)	\$ 3,305	\$ (3,612)	\$ 825
Gain (loss) on translation of intercompany receivables	2,555	(4,489)	3,468	(2,647)
<b>Net Income Hedges</b>				
Loss on foreign currency hedges	(340)		(378)	
Loss related to hedge activities	\$ (647)	\$ (1,184)	\$ (523)	\$ (1,822)

**Table of Contents****SonoSite, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(unaudited)****7. Segment reporting**

In August 2009, we acquired CDIC. We are currently in the process of fully integrating CDIC into our business and do not consider CDIC a separate reportable segment. We 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		Nine Months Ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
United States	\$ 26,917	\$ 33,929	\$ 74,036	\$ 84,321
Europe, Africa and the Middle East	12,240	13,445	40,586	46,624
Latin America and Canada	5,030	6,172	15,079	17,562
Asia Pacific	9,384	8,087	27,960	24,855
Total revenue	\$ 53,571	\$ 61,633	\$ 157,661	\$ 173,362

**8. Contingencies and Subsequent Events**

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 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.

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 ( the 412 patent ). We 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.

In October 2009, we settled all pending patent litigation worldwide with GE. Under the settlement agreement, both parties agreed to dismiss their claims against each other in all pending litigation. The parties entered into worldwide cross-licenses of the patents in litigation, including a license of the 412 patent by us to GE, and provided each other with mutual releases. In exchange for the 412 license, GE paid an up front fee of \$21 million to us and will also make ongoing royalty payments on US sales and production of hand-carried ultrasound systems. We will receive these royalty payments until the 412 patent expires in June 2016. As part of the settlement, we also entered an arrangement with GE to create a foundation to fund research, education and training of best practices for point-of-care ultrasound. Subsequent events have been measured



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through November 9, 2009, the date of issuance of our condensed consolidated financial statements.

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**SonoSite, Inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(unaudited)**

**9. Adjustments**

Our results for the nine months ended September 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 nine months ended September 30, 2009. These corrections were not deemed material to the estimated full year financial results for 2009.

**10. Recent accounting pronouncements**

In October 2009, the FASB issued Accounting Standards Update No. 2009-14, Software (Topic 985): Certain Revenue Arrangements That Include Software Elements (A Consensus of the FASB Emerging Issues Task Force) ( Update 14 ) which is an amendment to ASC 985. Update 14 focuses on determining which arrangements are within the scope of the software revenue guidance in ASC Topic 985 (previously included in AICPA Statement of Position no. 97-2, Software Revenue Recognition ) and which are not. Update 14 removes tangible products from the scope of the software revenue guidance if the products contain both software and nonsoftware components that function together to deliver a product's essential functionality and provides guidance on determining whether software deliverables in an arrangement that includes a tangible product are within the scope of the software revenue guidance. Update 14 becomes effective for revenue arrangements entered into for fiscal years beginning on or after June 15, 2010. Early adoption is permitted, but requires retrospective application from the beginning of the vendor's fiscal year. We are currently evaluating the impact this will have on us.

In October 2009, the FASB issued Accounting Standards Update No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (A Consensus of the FASB Emerging Issues Task Force) ( Update 13 ). Update 13 provides principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated, and the consideration allocated. It also requires an entity to allocate revenue in an arrangement using estimated selling prices of deliverables if a vendor does not have vendor-specific objective evidence or third-party evidence of selling price. The guidance eliminates the use of the residual method, requires entities to allocate revenue using the relative-selling-price method and significantly expands the disclosure requirements for multiple-deliverable revenue arrangements. Update 13 becomes effective for revenue arrangements entered into for fiscal years beginning on or after June 15, 2010. Early adoption is permitted, but requires retrospective application from the beginning of the vendor's fiscal year. We are currently evaluating the impact this will have on us.

In September 2009, the FASB issued Accounting Standards Update No. 2009-12, Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent) ( Update 12 ), which is an amendment to ASC 820 Fair Value Measurements and Disclosures. Update 12 clarifies the appropriate valuation techniques for measuring the fair value of investments in certain entities that calculate net asset value per share. Update 2009-12 permits a reporting entity to measure the fair value of an investment on the basis of the net asset value per share of the investment if the net asset value is calculated in a manner consistent with the measurement principles of Topic 946. Update 2009-12 is effective for interim and annual periods ending after December 15, 2009. We do not expect this to have an impact on us.

In August 2009, the FASB issued Accounting Standards Update No. 2009-05, Fair Value Measurements and Disclosures (Topic 820): Measuring Liabilities at Fair Value ( Update 05 ), which is an update to ASC 820 Fair Value Measurements and Disclosures. Update 05 clarifies the appropriate valuation techniques for measuring the fair value of a liability when a quoted price in an active market is not available. Update 2009-05 became effective for the first reporting period beginning after issuance. We do not expect Update 2009-05 to have a material impact on us.

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**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:

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 have continued 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.

On August 14, 2009, we acquired all of the outstanding stock of CardioDynamics International Corporation ( CDIC ), a leader in impedance cardiography ( ICG ) for noninvasive hemodynamic assessment that develops, manufactures, and markets ICG devices and sensors. The ICG product line provides non-invasive assessment of cardiac output and other hemodynamic parameters. The business combination enables us to expand our distribution platform and product offerings.

During the quarter, we also commenced international shipping of the NanoMaxx system, a 6 pound ultrasound tool designed for diagnostic imaging, clinical assessment, and procedural guidance in hospitals and in the physician's office. This recent addition to our suite of products recently received 510(k) clearance from the FDA for domestic sales, which will begin in the fourth quarter.

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**Table of Contents****Results of Operations****Revenue**

Revenue decreased to \$53.6 million for the three months ended September 30, 2009 from \$61.6 million for the three months ended September 30, 2008. Revenue decreased to \$157.7 million for the nine months ended September 30, 2009 from \$173.4 million for the nine months ended September 30, 2008. The decrease in the third quarter of 2009 compared to 2008 and for the nine months of 2009 compared to 2008 was attributable to a slowdown in hospital capital spending, offset by revenues of \$3.0 million from CDIC. Foreign exchange rates had no effect on revenues during the quarter but had an unfavorable impact of \$6.7 million, or 4% for year to date.

U.S. revenue decreased to \$26.9 million for the three months ended September 30, 2009 from \$33.9 million for the three months ended September 30, 2008. U.S. revenue decreased to \$74.0 million for the nine months ended September 30, 2009 from \$84.3 million for the nine months ended September 30, 2008. The decrease in the third quarter 2009 compared to 2008 and for the nine months of 2009 compared to 2008 was primarily attributable to a 23% decline in direct sales during the quarter and a 20% decline year to date primarily due to reduced hospital capital spending within the difficult economic environment, offset by CDIC sales of \$2.7 million.

Revenue from Europe, Africa and the Middle East decreased to \$12.2 million for the three months ended September 30, 2009 from \$13.4 million for the three months ended September 30, 2008. Revenue from Europe, Africa and the Middle East decreased to \$40.6 million for the nine months ended September 30, 2009 from \$46.6 million for the nine months ended September 30, 2008. The decrease during the quarter was due to order delays and an unfavorable foreign exchange impact of 4%. Year to date was negatively impacted by a foreign exchange impact of 12%.

Revenue from Latin America and Canada decreased to \$5.0 million for the three months ended September 30, 2009 from \$6.2 million for the three months ended September 30, 2008. Revenue from Latin America and Canada decreased to \$15.1 million for the nine months ended September 30, 2009 from \$17.6 million for the nine months ended September 30, 2008. The decrease in the third quarter 2009 compared to 2008 was primarily due to decreased sales in Latin America as well as an unfavorable exchange impact of 1% for the three months ended September 30, 2009. The decrease for the nine months of 2009 compared to 2008 was primarily due to decreased sales in Latin America as well as an unfavorable foreign exchange impact of 5% for year to date.

Revenue from Asia Pacific increased to \$9.4 million for the three months ended September 30, 2009 from \$8.1 million for the three months ended September 30, 2008. Revenue from Asia Pacific increased to \$28.0 million for the nine months ended September 30, 2009 from \$24.9 million for the nine months ended September 30, 2008. The increase in the three months was primarily due to increased sales of our higher-end products, as well as a favorable exchange rate of 7% for the three months ended September 30, 2009. The increase in the nine months was primarily due to increased sales of our higher-end products, partially offset by an unfavorable foreign exchange rate of 2% for year to date.

**Fiscal Year 2009 Outlook**

Given current economic conditions and foreign currency trends, we anticipate that revenue in 2009 will be less than 2008. We have introduced additional new products and features to develop the U.S. physician office market, and to expand our international operations. Considering current economic conditions, these initiatives may not be as successful as anticipated and we may encounter regulatory delays and other issues in selling our products. We may experience difficulties in integrating the CDIC products and sales channel. 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 70% for the three months ended September 30, 2009 and 2008. Gross margin was 70% for the nine months ended September 30, 2009 and 71% for the nine months ended September 30, 2008. The gross margin decreased over the prior year as a result of foreign currency impact of approximately 1%, which was partially offset by a reduction in material costs.

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**Table of Contents***Fiscal Year 2009 Outlook*

Although we expect our gross margin in 2009 to remain level with 2008, 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 introduction of new products; 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 \$6.5 million for the three months ended September 30, 2009, compared to \$7.4 million for the three months ended September 30, 2008. Research and development expenses were \$21.6 million for the nine months ended September 30, 2009, compared to \$20.6 million for the nine months ended September 30, 2008. The decrease in the third quarter of 2009 compared to 2008 was primarily attributable to a reduction in development costs due to the completion and launch of a new product offering. The increase in the nine months of 2009 compared to 2008 was primarily attributable to increased headcount and other costs related to development of new features and products.

Sales, general and administrative expenses were \$28.9 million for the three months ended September 30, 2009, compared to \$28.3 million for the three months ended September 30, 2008. Sales, general and administrative expenses were \$81.7 million for the nine months ended September 30, 2009, compared to \$86.7 million for the nine months ended September 30, 2008. The increase in the third quarter of 2009 compared to 2008 was primarily attributable to operations and integration costs of CDIC, offset by a reduction in legal costs. The decrease in the nine months was primarily attributable to reduced legal costs and compensation expense, and a favorable impact from foreign exchange rates. Included in operating expenses are integration related charges of \$4.0 million in the third quarter and \$4.1 million for the nine months ended of 2009.

During 2009, we incurred acquisition costs related to CDIC of \$1.0 million for the three months and \$1.5 million for year to date, offset by a bargain purchase gain of \$1.1 million for the three months and year to date.

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 in two installments from Zonare to SonoSite. We recognized a benefit of \$0.9 million in operating income for the nine months ended September 30, 2009 when final payment was received. We recognized a benefit of \$2.6 million in operating income for the three and nine months ended September 30, 2008.

*Fiscal Year 2009 Outlook*

We anticipate that operating expenses will decrease in 2009 compared to 2008 through reduced legal costs, incentive and stock compensation, and effective cost management.

***Other loss***

Total other loss was \$3.0 million for the three months ended September 30, 2009 compared to \$3.7 million for the three months ended September 30, 2008. Total other loss was \$5.5 million for the nine months ended September 30, 2009 compared to \$8.6 million for the nine months ended September 30, 2008. The decrease in loss for the three months ended September 30, 2009 was primarily attributable to lower interest as a result of less outstanding debt and lower losses related to hedges compared to the prior year, partially offset by lower interest income on our investment balances. The decrease in loss for the nine months ended September 30, 2009 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.



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Amounts reported in comparable prior periods have been restated due to the adoption of Financial Accounting Standards Board Accounting Standards Codification (ASC) 470-20, formerly Financial Accounting Standards Board Staff Position (FSP) APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement), 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 ASC 470-20, lower interest income due to lower interest rates, and lower gains from the repurchase of convertible senior notes.

### *Income tax (benefit) expense*

Income tax benefit was \$0.5 million for the three months ended September 30, 2009, compared to a provision of \$2.7 million for the three months ended September 30, 2008. Income tax provision was \$0.3 million for the nine months ended September 30, 2009, compared to \$3.9 million for the nine months ended September 30, 2008. The increase in our consolidated effective tax rate for the three months ended September 30, 2009 resulted from a low level of book income relative to permanent differences related to the research and development tax credit and domestic production activities tax deduction. The decrease in our consolidated effective tax rate for the nine months ended September 30, 2009, as compared to 2008, results primarily from the reinstatement of the U.S. research and development tax credit in the fourth quarter 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 ASC 470-20.

### *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 NanoMaxx, MicroMaxx system, M-Turbo system and S Series ultrasound tools, as well as our newly acquired BioZ systems 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 \$211.0 million as of September 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 \$36.9 million as of September 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 September 30, 2009, our investment in the Columbia Strategic Cash Portfolio has been fully liquidated.

Operating activities provided cash of \$8.9 million for the nine months ended September 30, 2009, compared to cash provided of \$18.0 million for the nine months ended September 30, 2008. Net income for the nine months ended September 30, 2009 was adjusted by stock-based compensation expense of \$5.2 million, depreciation and amortization of \$3.6 million, amortization of debt discount and debt issuance costs of \$3.8 million, deferred income taxes of \$1.2 million, a gain on convertible note repurchase of \$1.3 million, and a gain on the bargain purchase of CDIC of \$1.1 million. Operating assets and liabilities were primarily impacted by the timing of payments and receipts. For the nine month period ended September 30, 2009 operating assets provided \$11.6 million and operating liabilities used \$15.8 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 accrued expenses.

Investing activities provided cash of \$23.1 million for the nine months ended September 30, 2009, compared to \$59.2 million for the nine months ended September 30, 2008. The cash provided in 2009 was primarily due to the sale and maturity of investments of \$134.3 million, offset by the purchase of investment securities of \$100.4 million, the acquisition of CDIC of \$8.2 million, the purchase of property and equipment of \$2.3 million, and \$0.4 million of earn-out consideration associated with the acquisition of SonoMetric Health, Inc.





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Financing activities used cash of \$25.5 million for the nine months ended September 30, 2009, compared to cash provided of \$4.5 million for the nine months ended September 30, 2008. Cash used in financing activities was primarily due to the repurchase of our convertible debt and associated warrants for \$21.7 million, repayment of debt assumed in the CDIC acquisition of \$5.3 million and shares retired for taxes of \$1.3 million, partially offset by the sale of call options for \$1.4 million and proceeds from the exercise of stock-based awards totaling \$1.4 million.

We believe that our existing cash and cash generated from operations will be sufficient to fund our operations, capital expenditures and repurchases of convertible debt for the foreseeable future. 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 ASC 470-20, formerly FSP 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 convertible senior 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

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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.

*Business Combination.* In August 2009, we acquired all of the outstanding stock of CDIC and Medis. The purchase method of accounting was used to account for this acquisition. The cost of an acquisition is measured at the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. Because the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the excess of the value of the net assets acquired over the purchase price has been recorded as a gain on bargain purchase. We recorded identifiable assets including customer relationships, developed technology, trademarks, and internally developed software, which have lives from two to six years.

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**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 September 30, 2009, our investment portfolio consisted of \$36.9 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.

**Foreign currency risk**

Except for sales transacted by our wholly-owned subsidiaries, we transact substantially all our sales in US Dollars ( USD ); 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 September 30, 2009, 71% of our outstanding accounts receivable balance was from international customers, of which 54%, or \$21.1 million, was denominated in a currency other than USDs. Total sales for the three months ended September 30, 2009 denominated in a currency other than USDs were \$18.8 million, or 35% of total consolidated revenues. Total sales for the nine months ended September 30, 2009 denominated in a currency other than USDs were \$56.9 million, or 36% 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 as warranted in order to mitigate our collection risk.

We periodically enter into foreign currency forward contracts to reduce the impact of adverse fluctuations on earnings associated with foreign currency exchange rate changes. As of September 30, 2009, we had \$46.2 million in notional amount of foreign currency forward contracts that expire on October 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. Gains and losses in the fair value of these contracts are intended to offset the losses and gains, resulting from the changes in the underlying intercompany balances. The fair value of these contracts as of September 30, 2009 was not material to our results of operations or our financial position.

We use foreign currency forward contracts to hedge the impact of currency fluctuations on the translation of the financial statements of our foreign operations. As of September 30, 2009, we had \$7.3 million in notional amount of foreign currency forward contracts expiring at various dates through February 28, 2010. For the three months and nine months ended September 30, 2009, we recognized mark to market losses on these contracts of \$0.3 million and \$0.4 million.

Our foreign currency forward contracts 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. A sensitivity analysis of a change in the fair value of these contracts, totaling \$53.4 million in notional amount, indicates that if the USD weakened by 10% against the applicable foreign currency, the fair value of these contracts would decrease by approximately \$5.3 million. Conversely, if the USD strengthened by 10% against the applicable foreign currency, the fair value of these contracts would increase by approximately \$5.3 million. The offsetting gains and losses resulting from the changes in the intercompany balances as described above are not reflected in the sensitivity analysis above.

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### **Current Credit and Financial Markets**

The worldwide financial and credit crisis of the past year 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 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 September 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 third 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 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.

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 ( the 412 patent ). We 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.

In October 2009, we settled all pending patent litigation worldwide with GE. Under the settlement agreement, both parties agreed to dismiss their claims against each other in all pending litigation. The parties entered into worldwide cross-licenses of the patents in litigation, including a license of the 412 patent by us to GE, and provided each other with mutual releases. In exchange for the 412 license, GE paid an up front fee of \$21 million to us and will also make ongoing royalty payments on US sales and production of hand-carried ultrasound systems. We will receive

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these royalty payments until the 412 patent expires in June 2016. As part of the settlement, we also entered an arrangement with GE to create a foundation to fund research, education and training of best practices for point-of-care ultrasound.

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**Item 6. Exhibits**

**Exhibit**

<b>No.</b>	<b>Description</b>
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)

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**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: November 9, 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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**INDEX TO EXHIBITS**

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