SONOSITE INC
Form 10-K
March 12, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

x Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2008

OR

¨ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____.

Commission file no. 0-23791

SONOSITE, INC.

(Exact name of registrant as specified in its charter)

Washington	91-1405022
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

21919 30th Drive S.E.

Bothell, WA 98021-3904

(425) 951-1200

(Address and telephone number of registrant s principal executive offices)

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common stock, $0.01 par value

Indicate by check mark if the registrant is a well-known seasoned issuer (as defined in Rule 405 of the Securities Act). Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

The aggregate market value of the voting stock held by nonaffiliates of the registrant, based on the closing sale price of the registrant s Common Stock on June 30, 2008 as reported on the Nasdaq National Market, was $472,586,905.

As of February 19, 2009, there were 17,071,582 shares of the registrant s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this report, to the extent not set forth herein, is incorporated by reference from the registrant s definitive proxy statement relating to the annual meeting of shareholders to be held in 2009, which definitive proxy statement shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates.

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SONOSITE, INC.

ANNUAL REPORT ON FORM 10-K

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Trademarks

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PART I

Our disclosure and analysis in this report and in our 2008 Annual Report to shareholders, of which this report is a part, contain forward-looking statements. Forward-looking statements provide our current expectations or forecasts of future events. Forward-looking statements in this report include, without limitation:

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

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

We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures we make on related subjects in our future quarterly reports on Form 10-Q, future 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 under the caption Risk Factors in this report. 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.

ITEM 1. BUSINESS

Overview

We are the world leader in hand-carried ultrasound, or HCU, systems. We specialize in the development of HCU systems for use in a variety of medical specialties in a range of clinical settings at the point-of-care. Our proprietary technologies have enabled us to design HCU systems that combine high resolution, all-digital, broadband imaging with advanced features and capabilities typically found on cart-based ultrasound systems. We believe that the performance, size, durability, ease of use and cost-effectiveness of our products are expanding existing ultrasound markets, and are opening new markets by bringing ultrasound visualization out of the imaging lab to the point-of-care such as the patient s bedside or the physician s examining table for diagnosis and procedural guidance.

The large size, weight and complexity of traditional cart-based ultrasound systems typically require a physician or highly trained clinician to perform the examination in a centralized imaging department, such as a hospital s radiology department. Our strategic intent is to enable clinicians to use ultrasound in a variety of clinical settings by developing each potential market based on three fundamental tenets: (i) the design of high performance system hardware, software and transducers with application-specific settings and capabilities; (ii) the provision of educational training that ensures appropriate use of the equipment in the clinical setting; and (iii) the support of professional institutions and ultrasound thought leaders in the completion of use protocols and clinical research that accelerates the adoption of HCU to improve patient

outcomes. By providing ultrasound at

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the primary point-of-care, our systems expedite diagnosis and treatment in acute and critical care settings and provide visual guidance for interventional procedures. In outpatient settings, our systems can eliminate delays associated with the outpatient referral process. This increased accessibility is changing clinical practice, improving patient care and safety and has the potential to reduce healthcare costs through earlier diagnosis of diseases and conditions.

We design our products for applications where ultrasound has not typically been used such as emergency medicine, surgery, critical care, internal medicine and vascular access procedures as well as for imaging in traditional applications, such as radiology, cardiology, vascular medicine and obstetrics and gynecology (OB/Gyn). In addition, the U.S. military has successfully deployed our systems in traditional hospital settings, field hospitals and forward surgical teams in war zones and areas of conflict. We began shipping our first products in September 1999 and today have an installed base of approximately 50,000 systems worldwide.

Our fourth generation product platform is the basis of two product lines, the M-Turbo® system and the S Series ultrasound tools, which we introduced in October 2007. These products together with the MicroMaxx® system, our third generation of hand-carried technology and introduced in 2005, offer a broad-based product portfolio for hospital and physician office markets. Based on our proprietary Application Specific Integrated Circuit (ASIC) technology for high-resolution ultrasound imaging these systems offer image resolution comparable to costly, conventional cart-based ultrasound systems weighing over 200 pounds. A five-year warranty covering the system and SonoSite-manufactured transducers, comes standard with these products. In 2008, we introduced major upgrades for both the M-Turbo and S Series product lines which increased performance and expanded clinical capabilities. Additionally we introduced a specialized configuration of the M-Turbo product for the OB/Gyn market, and expanded the S Series product line by introducing customized configurations to address the musculoskeletal, gynecology, veterinary, and vascular access markets.

Our second generation product, the TITAN® system, began shipping in 2003. This system addresses point-of-care and traditional ultrasound markets. Our first generation of products includes the 180 and iLook® series. The SonoSite 180PLUS system is designed for general ultrasound imaging and the SonoHeart® ELITE is specifically configured for cardiovascular applications. The iLook 25 imaging tool is designed to provide visual guidance for physicians and nurses while performing vascular access procedures and the iLook 15 imaging tool is designed to provide imaging of the chest and abdomen.

We commenced operations as a division of ATL Ultrasound, Inc., or ATL (now a part of Philips Medical Systems). On April 6, 1998, we became an independent, publicly owned company through a distribution of one new share of our stock for every three shares of ATL stock held as of that date. ATL retained no ownership in SonoSite following the spin-off.

Medical Ultrasound Imaging

Ultrasound uses low power, high frequency sound waves to provide noninvasive, real-time images of the body s soft tissue, organs and blood flow. Ultrasound can be cost effective by eliminating the need for more time intensive, invasive and expensive procedures and allowing for earlier diagnosis of diseases and conditions. Further, it does not expose the patient to ionizing radiation that is present in X-ray and computed tomography technology. To generate an ultrasound image, a clinician places the transducer on the skin or in a body cavity near or by the targeted area of interest. Tissues and bodily fluids reflect the sound waves emitted by the transducer, which then receives these reflections. Based on these reflections, the ultrasound system s beamformer measures and organizes the sound waves and produces an image for visual examination, using digital or analog signal processing, or a combination of the two. Broadband digital signal processing technology, such as that used by our products, allows an ultrasound system to obtain and process greater amounts of information. Accordingly, digital ultrasound systems produce higher resolution images than analog and hybrid analog/digital ultrasound machines.

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Standard ultrasound imaging produces a two-dimensional image, known as grayscale or 2D imaging, which physicians use to diagnose, stage and monitor disease states and conditions. Color Doppler technology expands standard ultrasound imaging by generating a colorized image showing the presence and direction of blood flow. Through the use of software algorithms in the ultrasound system, clinicians can provide a quantitative assessment of anatomical structures and physiological functions such as blood flow velocity and cardiac ejection fraction.

Our Markets

According to a report by InMedica, a market research company that focuses on the medical device industry, the worldwide ultrasound market for HCU was $615.7 million in 2008, excluding upgrades and services. In the report, InMedica projected that the HCU market would grow to $1.2 billion in 2012, representing a compounded annual growth rate of approximately 18.4%. According to the report, HCU is the fastest growing sector of the ultrasound market and is being driven by the identification of new clinical applications and expansion into new geographic regions.

Our markets can be classified by location and clinical application. From a location perspective, we see our growth continuing to come from further penetration into the hospital market, the major source of our revenue today. Additionally, we see strong future growth opportunities from sales into the clinic or physician s office, as well as into alternate care sites. On a clinical application basis, within the hospital, we see accelerating growth in non-traditional or point-of-care ultrasound markets such as anesthesia and critical care. In the clinic or private practice office setting, despite the current economic condition we believe that slower growth in the more competitive markets, such as radiology, cardiology and OB/Gyn, will be balanced by accelerating growth trends and interest in outpatient physician office settings. We consider the use of HCU in the military and disaster settings as promising opportunities, as well as expanded use in mobile screening services and other non-clinical sites.

Our Strategy

Our goal is to lead in the design, development and commercialization of high-performance, innovative ultrasound technology and HCU systems. We plan to increase our share in markets that we currently serve and also seek growth by entering new markets with significant opportunities. Our strategy to achieve our objectives consists of the following key elements:

Continue to lead the HCU market by building upon and expanding product and technology leadership. We believe our products represent the most advanced and innovative technology available in HCU systems. We are committed to continuing to expand this technological advantage by further enhancing our existing products and creating new ones. As of December 31, 2008, we employed approximately 120 people in research and development. Since our inception in 1998, we have introduced four generations of our hand-carried technology, which have improved performance and expanded clinical capabilities of our systems. The M-Turbo system and S Series ultrasound tools, our fourth generation products based on ASIC technology, provide scalable technology platforms that will enable us to deliver products to specific clinical applications that vary by size, cost and performance.

Maximize the productivity of our direct sales force. As of December 31, 2008, we employed over 100 direct sales representatives in the U.S., Australia, Canada, France, Germany, Italy, Japan, Spain and the United Kingdom. To further enhance the productivity of our direct sales force, we will continue to:

- invest in training and educating our sales force;
- maximize sales to our installed base;
- provide education to increase market awareness and generate new customer leads; and
- expand our strategic alliances.

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Expand our strategic alliances. We believe that other markets offer opportunity for growth, but will require enhancements to our sales distribution channels. We intend to enter into new strategic alliances to develop markets within ultrasound or with ultrasound-dependent technologies. We believe that strategic alliances can accelerate market penetration to customers not currently served by our direct sales force.

Drive our technology across the point-of-care spectrum. We believe that the performance, mobility, durability and cost effectiveness of our products are resulting in the creation of new clinical markets for us. We are expanding the use of ultrasound beyond the imaging center to the patient point-of-care, such as the emergency room, the physician s office and other non-traditional ultrasound settings. With our SonoCalc® IMT software, which allows physicians to measure the wall thickness (known as the IMT) of the carotid artery, we have taken initial steps to enter the market for cardiovascular disease management. We believe that new markets like these will offer us significant potential for additional growth.

Acquisition of complimentary companies, products or technology. We believe that the acquisition of one or more medical device companies, products or technologies could expand our product portfolio and sales channels, create international operating leverage, improve marketing and other efficiencies and leverage manufacturing and supply chain economics.

Our Products

Our product portfolio consists of the M-Turbo system, the S Series ultrasound tools, the MicroMaxx system, the TITAN system, the 180 series and the iLook series. All SonoSite ultrasound systems offer a digital beamformer, broadband imaging, an integrated color display, a control panel, an alphanumeric keyboard and multiple caliper measurement tools. With the exception of the iLook series (which supports color power Doppler only), each of the systems provides 2/D velocity color Doppler, color power Doppler, M-mode, pulse wave and continuous wave Doppler imaging. All systems (except for the iLook) can be used with certain transducers that are capable of providing Tissue Harmonic Imaging, which uses high frequency imaging to optimize gray scale differentiation and optimize overall image quality. All systems (except for iLook) support basic ECG (electrocardiogram) synchronization to image gathering, essential for understanding cardiac cycle and anatomical variations. Image storage, image documentation to video printer or video recorder and direct personal computer connectivity are available on all SonoSite platforms. All systems are capable of operating on battery power when needed and are designed for the rigors of mobile use. We make and sell a broad array of transducers to use with our systems to address a full range of clinical applications.

In addition to the above, the M-Turbo, MicroMaxx and TITAN systems support dual screen imaging for comparative imaging. These systems can be used for stationary applications in a Mobile Docking Station (MDS), which supports connectivity to hospital information systems, multiple transducer connections and on-board documentation devices. The systems can be easily removed from the docking station to be hand-carried to the point-of-care. Unlike recently introduced convertible ultrasound products, the MDS does not contain any system electronics. All SonoSite systems are fully functional in all portable exam environments, whether or not connected to a docking station.

The following is a summary of our ultrasound product platforms:

M-Turbo System and S Series Ultrasound Tools. The M-Turbo and S Series products, first shipped in December 2007, deliver an exponential increase in processing power for superior image clarity across all exam types, plus seamless connectivity for digital image export in a rugged, easy to use form factor. Clinicians can export images easily to a USB storage device in standard PC formats for review or storage on a Windows® PC or Mac® computers.

The M-Turbo system, at 7.5 pounds and a complement of 14 transducers, can be configured for the full range of clinical and procedural guidance applications at the point-of-care including abdominal, nerve, vascular, cardiac, venous access, small part and superficial imaging.

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The S Series are the first ultrasound tools customized to specific clinical applications and designed to be wall or ceiling mounted or can be used from a stand. With the S Series products, clinicians need only to manipulate two controls depth and gain to get the image they need. Transducers, exam settings, software and algorithms are all specialized for the specific clinical application. Weighing 9.4 pounds, the S Series ultrasound tools S-FAST for emergency medicine, S-Nerve for regional anesthesia, S-ICU for critical care and S-Cath for interventional radiology and cardiac cath labs. In 2008, SonoSite introduced the S-MSK for musculoskeletal applications, the S-GYN and S-Women s Health.

Transducers are interchangeable between the M-Turbo and S Series product lines. A 5-year warranty comes standard on the system and most of the transducers. These systems may be upgraded with purchased software features that can be added through a USB drive.

MicroMaxx System. The MicroMaxx system, first shipped in June 2005, weighs 7.6 pounds (with battery). It has 14 transducers and can be configured for use in anesthesia, cardiology, critical and acute care, emergency medicine, OB/Gyn, preventive cardiology, radiology, surgery and vascular applications. A 5-year warranty comes standard on the system and most of the transducers.

SonoSite TITAN. The TITAN system, first shipped in June 2003, weighs 7.5 pounds. Like the MicroMaxx system, the TITAN system features a larger display screen than the 180 or iLook products and has removable memory flashcards for enhanced image or study storage.

SonoSite 180 Series. The 180 Series consists of the 180PLUS and SonoHeart Elite, each weighing approximately 5.4 pounds. The SonoSite 180PLUS system is a point-of-care ultrasound system for general diagnostic and procedural assistance imaging. It was our initial product that created the hand-carried ultrasound category. The SonoHeart ELITE system is a point-of-care ultrasound system with expanded measurement tools and clinical analysis packages intended for use by cardiologists and other healthcare providers in the cardiology or bedside assessment market. The SonoHeart ELITE has all the product features of the SonoSite 180PLUS.

iLook Series. The iLook series consists of the iLook 15 and 25, each weighing approximately 3 pounds. The iLook 15 tool, with its fixed curved array transducer, provides imaging for focused abdominal and cardiac applications. The iLook 25 tool, with its fixed linear transducer, enables the clinician to visualize a patient s vessels to aid in vascular access applications.

We also offer accessories and clinical education programs including:

Accessories. We offer a wide selection of accessories for our products. These include mobile docking stations, multiple transducer connections, image transfer and management software, printers, video recorders, auxiliary monitors, storage devices, carrying cases and disposable supplies.

Specialized training and education. We develop education programs independently and in partnership with numerous medical societies and other recognized experts in ultrasound education to provide courses for our customers through the SonoSite Institute for Training and Education. We have pioneered a unique online education site, which has been developed for the benefit of existing customers in the traditional and emerging markets that are new to the routine use of ultrasound. Additionally, with the introduction of the M-Turbo and S Series we developed the Education Key program a USB thumb drive that contains a combination of system operation video tutorials, application-specific video refresher programs that provide peer-to-peer instruction on how to perform specific exams and procedures and an image reference library of application specific sonographic anatomy for comparison purposes. As we develop new and emerging markets, we plan to continue to support the development of accredited and market-specific training materials, and expand the use of workshops in conjunction with recognized leaders in ultrasound.

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Sales and Marketing

We currently sell our products through sales channels comprised of direct sales force, independent third-party distributors, and strategic alliances. As of December 31, 2008, we employed over 100 direct sales representatives in the U.S. and in our wholly-owned subsidiaries located in Australia, Canada, France, Germany, India, Italy, Japan, Spain, and the United Kingdom. In addition to our direct sales, we sell products in over 100 countries through a network of independent third-party distributors. In addition, we employ regional distribution managers responsible for Africa, Asia, China, Europe, Middle East, and Latin America.

In the U.S., we have complemented our direct sales efforts by entering into group purchasing agreements with major healthcare group purchasing organizations (GPO). Currently, we have GPO supply agreements with various groups including Amerinet, Inc., Broadlane, Inc. (includes Kaiser Permanente, Tenet Healthcare and others), HealthTrust Purchasing Group, MedAssets HSCA, Inc., Novation LLC, and Premier, Inc. We also have two supply agreements with the U.S. government, specifically with the Defense Supply Center of Philadelphia and the Veteran s Administration. In the United Kingdom, we have a supply agreement with the Purchasing and Supply Agency of the National Health Service, which contracts on a national basis for the purchase of products and services.

We derived 48% of our revenue from domestic sales in 2008 compared to 51% in 2007 and 52% in 2006. We attribute revenue to a foreign country based on the location to which we ship our products. Products sold to the U.S. government but deployed in a foreign country are attributed to domestic revenue. Our quarterly revenue is affected by seasonality from year to year with the fourth quarter having the highest revenue, and first quarter being typically the lowest. Quarterly revenue patterns may be affected somewhat by large government orders or shipment of product inventory to new distributors. We currently have one reporting segment. For information regarding revenues and long-lived assets by geography, refer to Note 16 of our consolidated financial statements.

Patents and Intellectual Property Rights

We rely on a combination of patent, copyright, trademark and trade secret laws and other agreements with employees and third parties to establish and protect our proprietary rights. We require our officers, employees and consultants to enter into standard agreements containing provisions requiring confidentiality of proprietary information and assignment to us of all inventions made during the course of their employment or consulting relationship. We also enter into nondisclosure agreements with our commercial counterparties and limit access to, and distribution of, our proprietary information.

We are committed to developing and protecting our intellectual property and, where appropriate, filing patent applications to protect our technology. We hold 27 U.S. patents relating to various aspects of our products, including digital beamformers, beamforming capabilities, digital conversion circuitry, transceiver circuitry, designs and circuit integration. We hold 32 foreign patents relating to our products, and we currently have 42 patent applications pending in the U.S. and 46 pending registrations abroad.

We license ultrasound technology from ATL under a Technology Transfer and License Agreement executed at the time of our spin-off as a public company in 1998. Under that agreement, we took ownership of certain ultrasound technology developed as part of a government grant and also patent rights, which had been established or were being pursued for that technology. As part of this agreement, we also entered into a cross-license whereby we had the exclusive right to use certain ATL technology existing on April 6, 1998 or developed by ATL during the three-year period following April 6, 1998 in ultrasound systems weighing 15 pounds or less, and ATL had the exclusive right to use our technology existing on April 6, 1998 or developed by us during the same three-year period in ultrasound systems weighing more than 15 pounds. On April 6, 2003, this cross-license became nonexclusive and, except for the patented technology of each party, now extends to all ultrasound systems regardless of weight.

We hold a number of registered and unregistered trademarks, service names and domain names that are used in our business in the U.S. and overseas. Generally, federally registered trademarks offer protection for renewable terms of 10 years so long as the mark continues to be used in commerce.

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In order to protect or enforce our patent rights, we may initiate patent litigation. Additionally, others may initiate patent litigation against us. For further description of our litigation and the status of these proceedings, see Item 3, Legal Proceedings.

Competition

We currently face competition from companies that manufacture cart-based and portable ultrasound systems. Many of our competitors are larger and have greater resources than we do and offer a range of products broader than our products. The dominant competitors in this industry are GE Healthcare, a unit of General Electric Company (GE Healthcare), Siemens Medical Solutions (Siemens) and Philips Medical Systems, a division of Koninklijke Philips Electronics, N.V. (Philips). In addition, as the market for high-performance, HCU systems develops, we expect competition to increase as potential and existing competitors enter the portable market or modify their existing products to more closely approximate the combined portability, quality, performance and cost of our products. Our current competitors in the portable market include Siemens, GE Healthcare, Mindray Medical International Limited, Philips, Biosound Esaote, Inc., Terason, a division of TeraTech Corporation (Terason), Ultrasonix Medical Corporation, and Zonare.

Research and Development and Technology

We currently employ approximately 120 people in research and development. In 2008, 2007 and 2006, expenses attributable to research and development for our business totaled $28.7 million, $25.9 million and $20.2 million. We believe our products represent the most advanced and innovative technology in high-performance, HCU systems. We believe our technology gives us a competitive advantage, and we are committed to maintaining this advantage by continuing to enhance our existing products and create new ones.

Manufacturing

Final assembly and testing of all products is done in our facility in Bothell, Washington. We depend on suppliers, including some single-source suppliers, to provide highly specialized parts and subassemblies, such as custom-designed integrated circuits, circuit boards, cable assemblies and transducer components. We also depend on single-source suppliers to provide other components, such as image displays, batteries, capacitors and cables. We maintain inventories of components to meet near-term production requirements. While our suppliers have generally produced our components with acceptable quality, quantity and cost in the past, they have experienced periodic problems that have caused us delays in production. To date, these problems have not resulted in lost sales or lower demand.

Governmental Regulation

The manufacture and sale of our products are subject to extensive regulation by numerous governmental authorities, principally the U.S. Food and Drug Administration, (FDA), as well as several other state and foreign agencies. The FDA requires that we obtain a pre-market notification clearance under Section 510(k) of the Federal Food, Drug & Cosmetic Act prior to introducing our products to the market. By granting 510(k) clearance, the FDA indicates agreement with an applicant s determination that the product for which clearance has been sought is substantially equivalent to medical devices that were on the market prior to 1976 or have subsequently received clearance. The process of obtaining 510(k) clearance typically takes approximately two to three months, but it can take significantly longer. To date, all of our products have received 510(k) clearance.

Many of the regulations applicable to our products in foreign countries are similar to those of the FDA. Some foreign regulatory agencies require similar pre-market clearance or registration before our products can be marketed or offered for sale in their countries. Such foreign regulatory approvals may be longer or shorter than that required for FDA clearance and the requirements may differ significantly. The national health or social security organizations of certain countries may additionally require our products to be qualified before they can be marketed in those countries. We cannot be assured that such clearances will be obtained.

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We are subject to regulations in each of the foreign countries in which we sell products. Currently, our products bear a CE Mark, which indicates that our products comply with the requirements of the applicable European Union Medical Device Directive. Medical devices properly bearing the CE marking may be commercially distributed throughout the European Union. We have received certification from the British Standards Institute (BSI) for conformity with certain quality system standards allowing us to place the CE mark on our product lines. The quality system has been developed by the International Organization for Standardization to ensure that companies are aware of the standards of quality to which their products will be held worldwide. While no additional pre-market approvals in individual European Union countries are required prior to marketing a device bearing the CE marking, practical complications with respect to marketing introduction may occur. For example, differences among countries have arisen with regard to labeling requirements. We may not be successful in maintaining certification requirements necessary for distribution of our products in the European Union and failure to maintain the CE marking will preclude us from selling our products there.

To ensure that manufacturers adhere to good manufacturing practices, medical device manufacturers are routinely subject to periodic inspections by the FDA and may be inspected by foreign regulatory agencies from countries in which we do business. In addition, the BSI performs periodic assessments of our manufacturing processes.

Reimbursement

In the U.S., the Center for Medicare and Medicaid Services (CMS), has established rules governing the reimbursement for ultrasound and other healthcare services to healthcare providers treating Medicare patients. Under current CMS rules, payment amounts and conditions of coverage for ultrasound are generous enough to allow physicians to incorporate the use of ultrasound into their practice when clinically appropriate. Private insurance policies, based largely on Medicare policies, also currently support the continued use and adoption of ultrasound. The use of our products outside the U.S. is similarly affected by reimbursement policies adopted by foreign regulatory agencies and insurance carriers. For additional consideration of risks associated with Reimbursement, see Item 1A, Risk Factors.

Service and Warranty

Our warranty period is five years for the M-Turbo, S Series, and MicroMaxx systems. Our warranty period for our other products is one year. The warranty is included with the original purchase. In addition to our standard warranty, we offer extended warranty agreements for maintenance beyond the standard warranty period or for coverage above what is provided under the standard warranty. We repair equipment that is out of warranty on a time and materials basis. The warranty liability is summarized as follows (in thousands):

	Beginning of year	Charged to cost of revenue	Applied to liability	End of year
Year ended December 31, 2008	$ 4,045	$ 4,773	$ (1,724)	$ 7,094
Year ended December 31, 2007	$ 2,318	$ 3,160	$ (1,433)	$ 4,045
Year ended December 31, 2006	$ 995	$ 2,397	$ (1,074)	$ 2,318

Employees

As of December 31, 2008, we had approximately 640 employees, of which approximately 19% were engaged in product research and development, 22% in manufacturing, 45% in sales and marketing activities and the remaining 14% in administrative capacities, including executive, finance, legal, human resources, regulatory and information services and technology. Of these, approximately 470 are U.S. employees. There has never been a work stoppage and no employees are covered by collective bargaining agreements. We believe our employee relations are good.

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Available Information

We make available, free of charge on our website, copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, or Exchange Act, as soon as reasonably practicable after filing or furnishing the information to the Securities and Exchange Commission. The Internet address for the information is http://www.sonosite.com and then click on About SonoSite then For Investors . Our Code of Conduct, which is our written Code of Ethics under Section 406 of the Sarbanes-Oxley Act of 2002, is also available on our website.

ITEM 1A. RISK FACTORS.

Our operations and cash flows are subject to various risks and uncertainties, including those described below, which could adversely affect our business, financial condition, and the trading price of our common stock.

Current economic conditions have had and may continue to have an adverse impact on our business.

Global economic conditions directly influence our operating results. Current and future economic conditions that affect consumer healthcare spending as well as physician and hospital spending, including the level of unemployment, inflation, availability of credit, and the financial condition and growth prospects of our customers may adversely affect our business and results of operations. Additionally, if our suppliers face challenges in obtaining credit, in selling their products or otherwise in operating their businesses, they may become unable to continue to offer the materials we use to manufacture our products, which may adversely affect our business and results of operations.

We may face significant challenges if global economic conditions do not improve or continue to worsen, including reduced demand for our products and services, increased order cancellations and longer sales cycles and slower adoption of new technologies; increased difficulty in collecting accounts receivable and risk of excess and obsolete inventories; increased price competition in our served markets; supply chain interruptions, which could disrupt our ability to produce our products; and increased risk of impairment of investments, goodwill and intangible and long-lived assets.

Currency exchange rate fluctuations in various currencies in which we do business and longer receivables collection periods outside of the United States could adversely affect our business.

Total sales denominated in a currency other than USD were $78.2 million, or 32% of our total consolidated revenues for the year ended December 31, 2008. As a result, our results of operations could be adversely affected by certain movements in exchange rates. Although we take steps to hedge a substantial portion of our foreign currency exposures, there is no assurance that our hedging strategy will be successful or that the hedging markets will have sufficient liquidity or depth for us to implement our strategy in a cost effective manner.

Additionally, as of December 31, 2008, 66% of our accounts receivable balance was from international customers, of which 56%, or $24.1 million, was denominated in a currency other than USD. Although we regularly review our receivable positions in foreign countries for any indication that collection may be at risk, our revenue from international sales may be adversely affected by longer receivables collection periods and greater difficulty in receivables collection.

We may be unable to expand the market for our products to new applications and new users, which could limit our ability to grow our business.

We seek to sell our products to current users of ultrasound, as well as to physicians and other healthcare providers who do not currently use ultrasound. Our market focus, and we believe our greatest growth opportunities, will come from new point-of-care clinical applications and new users of ultrasound. Any new users of ultrasound will not only require training and education to properly administer ultrasound examinations but

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also must develop an appreciation of the treatment value of our products so that our products will become successfully integrated into their day-to-day practices. Although we have spent, and will continue to spend, considerable marketing resources educating potential customers about the value of HCU products in new applications, our efforts may be unsuccessful. If these potential customers are unable or unwilling to be trained due to cost, time constraints, unavailability of courses or other reasons, or if they consider our products nonessential to their medical practices, our ability to expand the market for our products and to increase our revenues could be limited.

Our efforts to integrate the business and technology of any future acquisition may result in significant costs or create significant disruptions that outweigh the benefits of any such acquisition.

In October 2008, we ended negotiations with an acquisition candidate. However, we intend to continue exploring the possible acquisition of one or more medical device companies or medical device products or technologies in an effort to expand our product portfolio, expand our sales channels, create international operating leverage, improve marketing and other efficiencies and leverage manufacturing and supply chain economics. If we are unable to identify suitable acquisition candidates or to successfully consummate and integrate acquisitions into our business, our ability to grow our business may be affected.

Any acquisition we do complete may be costly and difficult and we may experience:

- difficulty in integrating operations, including combining teams and processes in various functional areas;
- delays in realizing the benefits of the acquired company or technology;
- limited market acceptance of acquired products or technology;
- diversion of our management s time and attention from other business concerns;
- lack of or limited direct experience in new markets we may enter;
- difficulties in obtaining regulatory approvals or reimbursement codes for acquired technologies;
- increased risk of product liability actions from acquired products or technologies;
- additional costs, including fees and expenses of professionals involved in completing the integration process; and
- unexpected costs associated with existing liabilities of any acquired business.

In addition, an acquisition could materially impair our operating results by causing us to incur additional debt or requiring us to incur one-time charges. If we fail in our attempts to integrate any acquired business or technology, or if the costs and burdens of such acquisition or integration outweigh the benefits of such acquisition, our financial resources or financial results could be impaired.

If healthcare reimbursement policies place limits on which providers may receive payment for imaging services or substantially reduce reimbursement amounts or coverage for specific procedures, market acceptance of our products may be reduced.

Continued demand for our products depends in part on the extent to which our customers continue to receive reimbursement for the use of our products from third-party payers such as Medicare, Medicaid and private health insurers (and equivalent third-party payers in foreign countries).

Presently, reimbursement policies for physician-performed diagnostic imaging services are fairly unrestricted in the United States and payment levels are sufficient to enable providers to recoup the costs of purchasing ultrasound systems in a reasonable timeframe. The continuing efforts of governmental authorities, private health insurers and other third-party payers to contain or reduce the costs of healthcare could, however, result in reduced payment for imaging services or more restrictive payment policies for diagnostic imaging. Some private insurers have implemented imaging privileging

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programs as a means of controlling utilization of imaging services. Finally, both governmental and private third-party payers are calling for increasing amounts of clinical evidence of beneficial patient outcomes in addition to proof of clinical efficacy as a prerequisite to granting new or continued coverage for technologies and devices.

We may be unable to compete effectively and could fail to generate sufficient revenue to maintain our business.

Competition in the cart-based and portable ultrasound systems market is very significant. Our main competitors in this industry are GE Healthcare, Siemens, and Philips. These companies are very large global organizations that have the following competitive advantages over us:

- significantly greater financial and infrastructure resources;
- larger research and development staffs;
- greater experience in product manufacturing, marketing and distribution;
- greater brand name recognition; and
- long-standing relationships with many of our existing and potential customers.

These manufacturers of cart-based and portable ultrasound systems could use their greater resources to further increase the level of competition in the market through various means, including:

- price and payment terms that we are unable to match;
- marketing strategies that bundle the sale of portable systems with other medical products that we do not sell;
- technological innovation;
- market penetration and hospital systems integration that we cannot match;
- employee compensation that we cannot match; and
- complementary services such as warranty protection, maintenance and product training that are outside of the scope of our product offerings.

Existing product supply relationships between these competitors and our potential customers could adversely impact the level or rate of adoption of our products due to brand loyalty or preferred customer discounts. Competing portable or traditional cart-based ultrasound devices may be more accepted or cost-effective than our products. Competition from these companies for employees with experience in the primary point-of-care market could result in higher turnover of our employees. If we are unable to respond to competitive pressures within the cart-based and HCU markets, we could experience delayed or reduced market acceptance of our products, higher expenses and lower revenue.

We expect the market for high-performance HCU products and the competition in the HCU market will continue to increase as new and existing competitors enter the portable ultrasound market or modify their existing products to more closely approximate the combined portability, quality, performance and cost of our products. If we are unable to compete effectively with current or new entrants to the high-performance HCU market, we will be unable to generate sufficient revenue to maintain our business.

If our relationships with our distributors are unsuccessful, our ability to sell our products could be limited.

We currently depend on distributors to help promote market acceptance and demand for our products in countries in which we do not have a direct sales force. Distributors that are in the business of selling other medical products may not devote a sufficient level of resources and support required to generate awareness of our products and grow or maintain product sales. If our distributors are unwilling or unable to market and sell our products, or if they do not perform to our expectations, we could experience delayed or reduced market acceptance and sales of our products.

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In addition, disagreements with our distributors or non-performance by these third parties could lead to costly and time-consuming litigation or arbitration and disrupt distribution channels for a period of time and require us to re-establish a distribution channel.

We may be unable to effectively develop new and innovative products and product features that achieve market acceptance, which could result in our products becoming technologically obsolete in the ultrasound market.

Because substantially all of our revenue comes from the sales of our existing HCU systems and related products, in order to remain competitive, our future financial success will depend in large part upon our ability to successfully invent, deliver and market new and innovative products and product features. In 2008 and 2007, we released several new products, including the M-Turbo system and the S Series ultrasound tools which are customized for different clinical applications. The development of new, technologically advanced products and product features is a complex and uncertain process requiring great innovation and the ability to anticipate technological and market trends and needs. We may be unable to achieve or maintain market acceptance of any new products we develop, and we may be required to expend more costs than anticipated to successfully introduce these products. Without successful product innovation and market introduction of new offerings and improvements, our products will become technologically obsolete and we will be unable to compete effectively in the ultrasound market. Even with successful innovation and development, we cannot assure you that revenues from the sales of our HCU systems will continue to remain at or above current levels or that we will continue to be financially profitable.

Because technology innovation is complex, it can require long development and testing periods. If the launch of new products or product improvements is delayed for any reason, our business may be adversely affected. Factors which could cause delays in our product development or release schedules or cancellation of our product development projects include:

- research and development challenges;
- defects or errors in newly developed products or software for those products;
- third-party intellectual property rights that preclude us from pursuing a new product design; and
- the availability, cost and performance of supplies and components needed for new products.

We may experience delays in our innovation cycle, and in the scheduled introduction of future new products. Any such delays could adversely affect our ability to compete effectively in the ultrasound market and could adversely affect our operating results.

Existing or potential intellectual property claims and litigation either initiated by or against us may divert our resources and subject us to significant liability for damages, substantial litigation expense and the loss of our proprietary rights.

In order to protect or enforce our patent rights, we may initiate patent litigation. For example, in 2009, we initiated a lawsuit against Zonare Inc. for patent infringement, a case which settled in 2008.

Others may initiate patent litigation against us. For example, in 2007 and again in 2008, GE Healthcare initiated patent litigation against us, alleging that we infringed several of their patents, and attempting to invalidate one of our key patents (for a discussion of these matters, see Item 3, Legal Proceedings). If we fail to successfully defend claims against us, we may be required to pay monetary damages (including treble damages) and, unless we are able to redesign our products to avoid infringing the asserted patents or to license proprietary rights from them, we may be prevented from continuing to market and sell certain of our products, sales of which represent a substantial portion of our total revenue. If this outcome were to occur, we may be unable to redesign our products in a timely and cost effective manner, and licensing proprietary rights may not be possible on commercially reasonable terms, if at all. Even if we are successful in defending these actions and in proving infringement, we will incur substantial costs that could adversely affect our financial condition and the actions will be distracting to management.

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We may become subject to interference proceedings conducted in patent and trademark offices to determine the priority of inventions. There are numerous issued and pending patents in the ultrasound field. The validity and breadth of medical technology patents may involve complex legal and factual questions for which important legal principles may remain unresolved.

We may be liable for infringing the intellectual property of others as there could be existing patents of which we are unaware, or pending applications of which we are unaware which may later result in issued patents, that one or more of our products may infringe.

We may also become involved in the defense and prosecution, if necessary, of intellectual property suits, patent interferences, opposition proceedings and other administrative proceedings.

Involvement in intellectual property claims and litigation, including those described above, could have significant adverse consequences, including:

- diversion of management, scientific and financial resources;
- exposure to significant adverse judgments and financial liabilities;
- substantial litigation costs;
- product shipment delays and lost sales;
- inability to design around third party patents;
- modification of our products; or
- discontinuation of product sales.

If we are unable to protect our patents and proprietary rights, we may be unable to compete effectively and we may lose sources of revenue.

Much of our value arises out of our proprietary technology and intellectual property for the design, manufacture and use of point-of-care ultrasound imaging systems. We rely on patent, copyright, trade secret and trademark laws to protect our proprietary technology and limit the ability of others to compete with us using the same or similar technology. Third parties may infringe or misappropriate our intellectual property, which could harm our business.

We currently hold 59 U.S and foreign patents relating to our technology. A number of other patents are pending in the United States and in foreign jurisdictions. Although we enter into confidentiality agreements with our employees, consultants and strategic partners, and generally control access to and distribution of our proprietary information, the steps we have taken to protect our intellectual property may not prevent misappropriation. In addition, we do not know whether we will be able to defend our proprietary rights since the validity, enforceability and scope of protection of proprietary rights is still evolving.

Policing unauthorized use of our intellectual property is difficult, costly and time-intensive. We may fail to prevent misappropriation of our technology, particularly in countries where the laws may not protect our proprietary rights to the same extent as do the laws of the United States. If we cannot prevent other companies from using our proprietary technology or if our patents are found invalid or otherwise unenforceable, we may be unable to compete effectively against other manufacturers of ultrasound systems, which could decrease our market share.

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Changes in the healthcare industry could result in a reduction in the size of the market for our products or may require us to decrease the selling price for our products, either of which could have a negative impact on our financial performance.

Trends toward managed care, healthcare cost containment, and other changes in government and private sector initiatives in the United States and other countries in which we do business are placing increased emphasis on lowering the cost of medical therapies, which could adversely affect the demand for or the prices of our products. For example:

- major third-party payers of hospital and non-hospital based healthcare services, including Medicare, Medicaid and private healthcare insurers, are considering revising their payment methodologies which may result in stricter standards for reimbursement of imaging charges and/or a lower or more bundled payment;
- numerous legislative proposals have been considered that would result in major reforms in the U.S. and foreign healthcare systems that could harm our business;
- there has been a consolidation among healthcare facilities and purchasers of medical devices in the United States and foreign countries who prefer to limit the number of suppliers from whom they purchase medical products, and these entities may decide to stop purchasing our products or demand discounts on our prices;
- there is economic pressure to contain healthcare costs in worldwide markets; and
- there are proposed and existing laws and regulations in domestic and international markets regulating pricing and profitability of companies in the healthcare industry.

These trends could lead to pressure to reduce prices for our products and could cause a decrease in the size of the market that could adversely affect our revenue and profitability, which could harm our business.

We may be unable to predict our sales and plan manufacturing requirements with accuracy, which may adversely affect our operating results.

Our customers typically order products on a purchase order basis. In some circumstances, customer orders may be cancelled, changed or delayed on short notice. Lack of significant order backlog makes it difficult for us to forecast future sales with certainty and could result in over or under production, which could lead to higher expense, lower than anticipated revenue, and reduced gross margin. Varying quarterly demands from our customers, particularly as we introduce new products, also make it difficult to accurately forecast component and product requirements, exposing us to the following risks:

- If we overestimate our requirements, we may be obligated to purchase more components or third-party products than we need; and
- If we underestimate our requirements or experience shortages of product components from time to time, we could experience an interruption in revenue, because our third-party manufacturers and suppliers may have an inadequate product or product component inventory to satisfy our requirements.

The final assembly and testing of our products is done at our Bothell, Washington factory where we integrate different components manufactured by various suppliers. If we encounter supplier, regulatory, engineering or technical difficulties in manufacturing on account of events at our factory or our suppliers factories, we may incur delays in delivery of these products to customers and that could adversely affect our revenues.

If our suppliers, including our single-source suppliers, fail to supply us with the components that we need to manufacture our products on a timely basis, we could experience production delays, cost increases and lost sales.

We depend on suppliers, including some single-source suppliers, to provide highly specialized parts, such as custom-designed integrated circuits, cable assemblies and transducer components. We also depend on single-source suppliers to provide other components, such as image displays, batteries, capacitors and cables. We do not

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maintain significant inventories of certain components, and may experience an interruption of supply if a supplier is unable or unwilling to meet our time, quantity and quality requirements. There are relatively few alternative sources of supply for some of these components. An increase in demand for some parts by other companies could also interrupt our supply of components. We have in the past experienced supply problems in timeliness and quality, but to date these problems have not resulted in lost sales or lower demand. Nevertheless, if we experience an interruption of supply or are required to switch suppliers, the manufacture and delivery of our products could be interrupted, our manufacturing costs could substantially increase and we could lose substantial amounts of product sales.

In addition, our circuit boards are produced in Singapore by one of the world s largest electronic manufacturing services suppliers. These circuit boards are highly customized and securing a different source of supply for this critical component of our product would be particularly difficult. If we experience delays in the receipt or deterioration in product yields of these critical components, we may experience delays in manufacturing or an increase in costs resulting in lost sales or a deterioration in gross margin.

If we are unable to overcome the risks inherent in international business activities, the growth of our business may be limited and our profitability could decline.

We have ten wholly owned subsidiaries located in Australia, Canada, China, France, Germany, India, Italy, Japan, Spain, and the United Kingdom. The percentage of our total revenue originating outside the United States equaled 52%, 49% and 48% for the years ended December 31, 2008, 2007 and 2006, respectively. Successful maintenance of these international operations requires us to:

- maintain an efficient and self-reliant local infrastructure;
- continue to attract, hire, train, manage and retain qualified local sales and administrative personnel;
- continue to identify new non-U.S. distributors and maintain our relationship with our existing distributors;
- comply with diverse and potentially burdensome local regulatory requirements and export laws, including license requirements, trade restrictions and tariff increases; and
- maintain complex information, financial, distribution and control systems.

Our presence in international markets has required, and will continue to require, substantial financial and managerial resources. The costs of maintaining our presence in international markets are unpredictable, difficult to control and may exceed budgeted amounts. In addition, we may be subject to the following conditions in countries where we conduct our operations:

- adverse regional political or economic conditions;
- currency exchange rate fluctuations;
- difficulty in enforcing any judgment against non-U.S. distributors or other third parties upon which our business is heavily dependent; and
- reduced protection for our intellectual property rights.

Despite our expenditures and efforts internationally to mitigate the challenges above, we may not continue to generate a proportional substantial increase in international revenue, and such a deficiency would impair our operating results.

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If we, or our suppliers, fail to comply with U.S. and foreign governmental regulations applicable to our products and manufacturing practices, we could experience product introduction delays, production delays, cost increases and lost sales and our future revenues may be adversely affected.

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

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

The process for obtaining regulatory approval can be lengthy and expensive, and the results are unpredictable. If we are unable to obtain clearances or approvals needed to market existing or new products, or obtain such clearances or approvals in a timely manner, our revenues and profitability could be adversely affected. Moreover, clearances and approvals, if granted, may limit the uses for which a product may be marketed, which could reduce or eliminate the commercial benefit of manufacturing any such product.

To ensure that manufacturers adhere to good manufacturing practices, medical device manufacturers are routinely subject to periodic inspections by the FDA and may be inspected by foreign regulatory agencies from countries in which we do business. In addition, BSI performs periodic assessments of our manufacturing processes and quality system. Compliance with the regulations of various agencies, including the Environmental Protection Agency and the Occupational Safety and Health Administration, may require us to incur substantial costs and may delay or prevent the introduction of new or improved products. Although to date these actions by regulatory bodies have not required us to incur substantial costs or delay product shipments, we expect to experience further inspections and incur additional costs as a result of governmental regulation.

Failure to comply with applicable regulatory requirements can result in enforcement action, including product recall, the issuance of fines, injunctions, civil and criminal penalties, detaining or banning our products, and operating restrictions. Our third-party medical device manufacturers may also be subject to the same sanctions if they fail to comply with the laws and regulations and, as a result, may fail to supply us with components required to manufacture our products.

A failure to manage our growth could impair our ability to achieve our business objectives.

We have experienced rapid and substantial growth in recent years. Our revenue increased to $243.5 million in 2008 from $205.1 million in 2007 and $171.1 million in 2006. Our growth could strain our existing management, operational and financial resources and, if we are unable to manage this growth successfully, our business and financial performance will be adversely affected. In order to manage our growth effectively, we will need to expand our sales, manufacturing and quality assurance staff, and improve the productivity and efficiency of our existing operational, financial, international support staff and our management and information systems. We may be unable to hire and retain the personnel necessary to operate and expand our business. We also may be unable to increase the productivity and efficiency of our existing resources.

Our reliance on a single manufacturing facility may expose us to enhanced risk from natural disasters or other unforeseen catastrophic events.

Our manufacturing facilities are located in two buildings in Bothell, Washington, in close proximity to each other. Despite precautions taken by us, a natural disaster such as an earthquake or other unanticipated catastrophic events at this location could significantly impair our ability to manufacture our products and operate our business. Our facilities and certain manufacturing equipment would be difficult to replace and could require

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substantial replacement lead-time. Such catastrophic events may also destroy any inventory of product or components. While we carry insurance for natural disasters and business interruption for our Bothell facilities, the occurrence of such an event could result in losses that exceed the amount of our insurance coverage, which would impair our financial results.

We may incur greater than expected warranty expense.

We expect our warranty liability and expense to continue to increase significantly due to the five-year warranty offered with the MicroMaxx system, M-Turbo system, and S Series ultrasound tools. Should actual failure rates and repair or replacement costs differ from our estimates, additional warranty expense may be incurred and our financial results may be materially affected.

The loss of key employees or management personnel could impair our ability to achieve our business objectives and negatively affect our financial results.

Our success depends heavily on our ability to retain the services of certain key employees or certain technical expertise. Competition among medical device companies for qualified employees is intense. We may fail to retain these key employees, and we may fail to attract qualified replacements if they do leave. We do not maintain key-person insurance on any of our employees. We do not have employment agreements with any of our employees except for employees in certain countries outside the United States and change in control agreements with certain members of senior management. The loss of any of our key employees could significantly delay or prevent the achievement of our product development or business objectives.

In addition, our future success will depend, to a significant extent, on the ability of our management to operate effectively, both individually and as a group. We must successfully manage transition and replacement issues that may result from the departure or retirement of members of our senior management. Transitions of management personnel may cause disruption to our operations or customer relationships, or a decline in our financial results.

Our results of operations are subject to significant quarterly variation.

Our quarterly operating results may vary significantly due to a combination of factors, many of which are beyond our control. These factors include:

- the timing of new product introductions by us or our competitors;
- the timing of regulatory approvals;
- the timing of orders from major customers and distributors, including bulk orders from governmental entities and demo orders from new distributors;
- seasonal buying patterns of our customers;
- development and promotional expenses relating to new product introductions;
- the revenue mix by product and geography;
- changes in pricing policies by us or our competitors;

fluctuations in foreign exchange rates;

writeoffs resulting from obsolete inventory;

fluctuations in our effective tax rates;

our ability to meet demand for our products;

the market acceptance of our products;

legal costs and the results of litigation;

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changes in distribution channels; and

the ability of our sales force to effectively market and sell our products.

Accordingly, our quarterly sales and operating results may vary significantly in the future, and period-to-period comparisons of our results of operations may not be meaningful and should not be relied upon as indicators of future performance.

Seasonality and concentration of revenues at the end of the quarter could cause our revenues to fall below the expectations of securities analysts and investors, resulting in a decrease in our stock price.

As a result of customer buying patterns and the efforts of our sales force to meet or exceed quarterly and year-end quotas, historically we have earned a substantial portion of each year s revenues during the last quarter and a substantial portion of each quarter s revenues during its last month. If expected revenues at the end of any quarter are delayed, our revenues for that quarter could fall below the expectations of securities analysts and investors, resulting in a decrease in our stock price.

Product liability and other claims and product field actions initiated against us could increase our costs, delay or reduce our sales and damage our reputation, adversely affecting our financial condition.

Our business exposes us to the risk of product liability, malpractice or warranty claims inherent in the sale and support of medical device products, including those based on claims that the use or failure of one of our products resulted in a misdiagnosis or harm to a patient. Such claims may cause financial loss, damage our reputation by raising questions about our products safety and efficacy, and could interfere with our efforts to market our products. Although to date we have not been involved in any medical malpractice or product liability litigation, we may incur significant liability if such litigation were to occur. We may also face adverse publicity resulting from product field actions or regulatory proceedings brought against us. Although we currently maintain liability insurance in amounts we believe are commercially reasonable, any product liability we incur may exceed our insurance coverage. Liability insurance is expensive and may cease to be available on acceptable terms, if at all. A product liability or other claim or product field action not covered by our insurance or exceeding our coverage could significantly impair our financial condition. In addition, a product field action or a liability claim against us could significantly harm our reputation and make it more difficult to obtain the funding and commercial relationships necessary to maintain our business.

We may be unable to sustain or increase our profitability.

We have been profitable since 2004, but we may be unable to sustain or increase future profitability on a quarterly or annual basis. We may incur losses if we cannot increase or sustain our revenue. We expect to lower operating expenses in 2009 through cost management; but we expect that our operating expenses will increase thereafter as we expand our product development activities, our sales and marketing infrastructure, our administrative support and our product offerings. Additionally, we expect operating expenses would increase as we pursue the acquisition of companies or technologies to further our growth. Our expansion and acquisition efforts, to be successful, may require more funding than we currently anticipate.

Our investment securities may be adversely impacted by economic factors beyond our control and we may incur additional impairment charges to our investment portfolio.

As of December 31, 2008, we had $2.8 million in the Columbia Strategic Cash Portfolio, which is in the process of liquidation. In our judgment this investment, which is classified as a money market account, has experienced a decline in fair value that is other than temporary, accordingly we have recognized an impairment loss of $0.7 million in 2008. Distributions from this portfolio are solely at the discretion of the portfolio manager. We anticipate that $2.2 million will be distributed from this portfolio during 2009, which is recorded as a short-term investment, and $0.6 million will be distributed after 2009, which is recorded as a long-term investment.

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The credit and capital markets deteriorated in 2008 and may continue to deteriorate in 2009. These markets may deteriorate further and we may incur additional impairments to our investment portfolio, which could negatively affect our financial condition, cash flow and reported earnings.

Conversion of our convertible senior notes will dilute the ownership interest of shareholders at the time of conversion.

Upon conversion of some or all of our senior notes the ownership interests of shareholders may be diluted. Any sales in the public market of the common stock issuable upon such conversion could adversely affect prevailing market prices of our common stock. In addition, the existence of the senior notes may encourage short selling by market participants because the conversion of the notes could be used to satisfy short positions, or anticipated conversion of the notes into shares of our common stock could depress the price of our common stock.

In addition, if a fundamental change occurs, under certain circumstances we will adjust the conversion rate by a number of shares of our common stock for notes converted in connection with such fundamental change. The adjustment to the conversion rate will be determined based on the date on which the fundamental change becomes effective and the price paid per share of our common stock in such transaction, as described under the terms of the senior notes.

As more fully defined in the indenture applicable to the notes, a fundamental change will be deemed to have occurred upon the consummation of certain significant corporate transactions, including for example, the acquisition by one party or group of more than 50% of the voting power of our common equity, the consummation of certain recapitalizations, consolidations or mergers, the sale of all or substantially all of our assets, shareholder approval of our liquidation or dissolution, the failure of our common stock to be listed on any U.S. national securities exchange or a change in the composition of our board of directors as a result of which our incumbent directors, or directors appointed by our incumbent directors, do not constitute a majority of our board.

Sales of a significant number of shares of our common stock in the public markets, or the perception of such sales, could depress the market price of our common stock.

Sales of a substantial number of shares of our common stock or other equity-related securities in the public markets could depress the market price of our common stock, and impair our ability to raise capital through the sale of additional equity securities. We cannot predict the effect that future sales of our common stock or other equity-related securities would have on the market price of our common stock. The price of our common stock could be affected by possible sales of our common stock by investors who view the notes as a more attractive means of equity participation in our company and by hedging or arbitrage trading activity, which we expect to occur involving our common stock. This hedging or arbitrage could, in turn, affect the market price of our common stock.

The convertible note hedge and warrant transactions associated with our convertible senior notes may affect the value of our common stock.

The convertible note hedge and warrant transactions associated with our convertible senior notes may affect the value of our common stock. In connection with the pricing of our convertible senior notes, we entered into a convertible note hedge transaction with an option counterparty. We also entered into a warrant transaction with this option counterparty. The convertible note hedge transaction covers approximately 42% of any converted notes, and is expected to reduce potential dilution to our common stock upon any such conversion. However, the warrant transaction could separately have a dilutive effect on our earnings per share to the extent that the market value per share of our common stock exceeds the applicable strike price of the warrants.

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In connection with establishing its initial hedge of these transactions, the option counterparty or its affiliates:

- entered into various derivative transactions with respect to our common stock concurrently with or shortly after the pricing of the notes; and

- may enter into or unwind various derivative transactions with respect to our common stock and/or purchase or sell our common stock in secondary market transactions following the pricing of the notes (and would likely do so during any observation period related to the conversion of the notes).

These activities could have the effect of increasing or preventing a decline in the price of our common stock concurrently with or shortly after the pricing of the notes and during any observation period related to a conversion of the notes.

In addition, the option counterparty or its affiliates will likely modify its hedge position from time to time prior to conversion or maturity of the notes by purchasing and selling our common stock, other of our securities or other instruments it may wish to use in connection with such hedging. In particular, such hedging activity would likely occur during any observation period for a conversion of notes, which may have a negative effect on the value of the consideration received in relation to the conversion of those notes.

We intend to exercise options we hold under the convertible note hedge transaction whenever notes are converted. In order to unwind its hedge position with respect to those exercised options, the option counterparty or its affiliates would expect to sell shares of our common stock in secondary market transactions or unwind various derivative transactions with respect to our common stock during the observation period for the converted notes. We have also agreed to indemnify the option counterparties for losses incurred in connection with a potential unwinding of its hedge positions under certain circumstances.

The potential effect, if any, of any of these transactions and activities on the market price of our common stock will depend in part on market conditions and cannot be ascertained as of the date of this annual report. Any of these activities could adversely affect the price of our common stock and, as a result, the value of the consideration and the number of shares of our common stock, if any, that the noteholders would receive upon the conversion of the notes.

If we fail to comply with our obligations in our license with ATL, we could lose license rights that are important to our business.

We license certain technology from ATL that is incorporated into our single technology platform, and we use this ATL technology in all of our HCU systems. A substantial majority of our revenue is attributable to products incorporating this ATL technology.

ATL may terminate our license in the event of an uncured material default by us in our obligations under the license agreement. The termination or other loss of our license to use ATL technology would significantly impair our ability to manufacture, market and sell our products. If this license is terminated, we may be unable to generate sufficient revenue to maintain our business.

If we incur a tax liability in connection with our spin-off from ATL, we would be required to pay a potentially significant expense, which would diminish our financial resources.

Our spin-off was treated by ATL as a tax-free spin-off under Section 355 of the Internal Revenue Code of 1986, or the Code. If ATL were to recognize a taxable gain from the spin-off, the Internal Revenue Service, or IRS, could impose that liability on any member of the ATL consolidated group as constituted prior to the spin-off, including us. Generally, the IRS may assert that our spin-off from ATL is a taxable transaction until the expiration of the statute of limitations applicable to ATL with respect to the spin-off transaction. The expiration of the statute of limitations with respect to the spin-off transaction depends upon the actions and tax filings of ATL and the special rules applicable to spin-offs in general, which special rules could result in the extension of the general statute of limitations for an indefinite period of time. In the event of a tax liability, ATL has agreed to

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cover 85% of any such liability, unless the tax is imposed due to our actions solely or by ATL solely, in which case, we have agreed with ATL that the party who is solely at fault shall bear all of the tax liability. We are unaware of any actions that would result in a tax liability to us under the indemnity agreement regarding the spin-off transaction. We are aware that ATL was acquired in a transaction subsequent to the spin-off transaction, which could potentially result in the spin-off being treated as a taxable transaction, but which resulting tax liability in our view would be the sole responsibility of ATL pursuant to our agreement with ATL. ATL may refuse, however, to indemnify us for a tax liability arising out of the spin-off transaction or may argue that it did not cause the tax liability to be imposed. In such event, we may incur a significant expense for all or a portion of the taxes related to the spin-off.

Our articles of incorporation, bylaws, rights plan and Washington law contain provisions that could discourage a change in control.

Certain provisions of our restated articles of incorporation and bylaws, our shareholder rights plan and Washington law would make it more difficult for a third party to acquire us, even if doing so would be beneficial for our shareholders. This could limit the price that certain investors might be willing to pay in the future for shares of our common stock. For example, certain provisions of our articles of incorporation or bylaws:

- allow our board to issue preferred stock without any vote or further action by the shareholders;
- limit the right of shareholders to act by written consent without a meeting;
- eliminate cumulative voting in the election of directors by holders of our common stock; and
- specify a minimum threshold for shareholders to call a special meeting.

We have adopted a shareholder rights plan, which is triggered upon commencement or announcement of a hostile tender offer or when any one person or group acquires 20% or more of our common stock. Once triggered, the rights plan would result in the issuance of preferred stock to the holders of our common stock other than the acquirer. In November 2007, we renewed this plan until April 5, 2013.

We are also subject to certain provisions of Washington law that could delay or make more difficult a merger, tender offer or proxy contest involving us. In particular, Chapter 23B.19 of the Washington Business Corporation Act prohibits corporations incorporated in Washington from engaging in certain business combinations with any interested shareholder for a period of five years unless specific conditions are met.

These provisions of our restated articles of incorporation, bylaws and rights plan and Washington law could have the effect of delaying, deferring or preventing a change in control of us, including, without limitation, discouraging a proxy contest or making more difficult the acquisition of a substantial block of our common stock. The provisions could also limit the price that investors might be willing to pay in the future for shares of our common stock.

ITEM 1B. UNRESOLVED SEC STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our principal offices are located in Bothell, Washington, where we lease two buildings totaling approximately 125,000 square feet. These facilities include approximately 78,000 square feet of office space and 47,000 square feet of manufacturing and warehouse space. The leases run through 2014. Additionally, we lease smaller office facilities at foreign locations in which we have operations.

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ITEM 3. LEGAL PROCEEDINGS

On February 21, 2007, we filed a patent infringement suit against Zonare Medical Systems, Inc. (Zonare) in the federal district court of the Central District of California alleging that Zonare infringed our U.S. patent 5,722,412 through sales of its z.one ultrasound system. On March 14, 2007, Zonare filed an answer to our claim which included a counterclaim against us alleging that our products infringe its U.S. patent 6,980,419 related to its portable docking station. On July 16, 2008, we settled all claims and counterclaims in this suit with Zonare. The parties entered into a settlement agreement that included among other terms, a cross license of the patents-in-suit limited to certain existing products of each party, and mutual releases and covenants not to sue for a certain period of time. Net income in both the third quarter and nine month period of 2008 included a $1.5 million after-tax benefit for the settlement of the Zonare patent lawsuit.

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, the parties filed a stipulation for dismissal without prejudice for the remaining claims and counterclaims for the three remaining patents that have yet to be ruled on by summary judgment in this case, thereby negating the need for a trial. On July 31, 2008, the court granted the parties request for dismissal of the remaining claims and counterclaims that had not been ruled on by the judge. The parties have appealed certain of the trial court s summary judgment decisions and other rulings to the Court of Appeals for the Federal Circuit. We do not expect an appellate decision until the second half of 2009.

On May 22, 2008, GE filed a second suit in the same federal court in Wisconsin seeking to invalidate our U.S. patent 5,722,412. We are defending this lawsuit and expect to go to trial in June 2009.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our shareholders during the fourth quarter of the year ended December 31, 2008.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is traded on the Nasdaq National Market under the symbol SONO. The high and low sales prices for our common stock for each quarter are listed below. These prices reflect interdealer prices, without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

Year	High	Low
2008		
Fourth quarter	$ 31.29	$ 15.62
Third quarter	$ 38.74	$ 27.17
Second quarter	$ 33.45	$ 27.20
First quarter	$ 39.20	$ 24.57
2007		
Fourth quarter	$ 37.00	$ 30.47
Third quarter	$ 36.93	$ 26.50
Second quarter	$ 32.78	$ 27.25
First quarter	$ 33.80	$ 26.91

Dividends

We have not declared or paid cash dividends on our common stock. We currently intend to retain all earnings, if any, for future growth and, therefore, do not intend to pay cash dividends on our common stock in the foreseeable future.

Equity Compensation Plan Information

The equity compensation plan information is presented under Part III, Item 12 of this Form 10-K.

Issuer Purchases of Equity Securities

There were no shares repurchased by SonoSite during the fourth quarter of 2008.

Sales of Unregistered Securities

There were no sales of unregistered securities by SonoSite in 2008.

Holders

As of February 19, 2009, there were 13,948 holders of record of our common stock. This figure does not include the number of shareholders whose shares are held of record by a broker or clearing agency, but does include each such brokerage house or clearing agency as a single holder of record.

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Performance Graph

The following performance graph compares the performance of SonoSite s common stock during the five-year period from December 31, 2004 through December 31, 2008 with the performance of the Nasdaq National Market, U.S. Index and the Nasdaq Medical Devices, Instruments and Supplies, Manufacturers Stocks Index. The graph plots the changes in value of an initial $100 investment over the indicated time periods, assuming all dividends are reinvested. Stock prices shown for the common stock are historical and not indicative of future price performances.

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ITEM 6. SELECTED FINANCIAL DATA

The selected financial data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and Notes thereto included elsewhere in this report.

	For the Years Ended December 31,				
	2008	2007	2006	2005	2004
	(in thousands, except per share data)				
Statement of Income Data					
Revenue	$ 243,524	$ 205,068	$ 171,083	$ 147,491	$ 115,817
Cost of revenue	73,715	62,505	49,673	43,652	37,755
Gross margin	169,809	142,563	121,410	103,839	78,062
Operating expenses:					
Research and development	28,698	25,872	20,183	15,195	12,644
Sales, general and administrative	118,679	112,240	97,391	81,752	62,120
Total operating expenses	147,377	138,112	117,574	96,947	74,764
Other income:					
Interest income	9,089	9,662	3,683	1,753	963
Interest expense	(9,009)	(4,371)		(2)	
Other income (loss)	11,571	1,274	294	(795)	(601)
Total other income	11,651	6,565	3,977	956	362
Income before income taxes	34,083	11,016	7,813	7,848	3,660
Income tax provision (benefit)	13,497	4,132	582	2,412	(19,312)
Net income	$ 20,586	$ 6,884	$ 7,231	$ 5,436	$ 22,972
Net income per share:					
Basic	$ 1.22	$ 0.41	$ 0.44	$ 0.35	$ 1.55
Diluted	$ 1.18	$ 0.40	$ 0.43	$ 0.34	$ 1.46
Shares used in computing net income per share:					
Basic	16,892	16,621	16,274	15,549	14,829
Diluted	17,486	17,168	16,857	16,175	15,737

	As of December 31,				
	2008	2007	2006	2005	2004
	(in thousands)				
Balance Sheet Data					
Cash and cash equivalents	$ 209,258	$ 188,701	$ 45,673	$ 26,809	$ 17,272
Working capital	349,462	383,249	147,302	104,999	69,370
Total assets	429,287	465,738	211,894	174,548	155,092
Long-term debt	144,745	225,000			
Total shareholders equity	229,927	192,862	181,031	152,042	133,235

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 HCU 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 also investing in research and development in existing and new lines of business and other areas that we believe may contribute to our long-term growth. Recognizing that one of our greatest challenges is the current state of the global economy, we are focused on increasing sales force efficiency and effective cost management.

Over the last few years, we have laid a foundation for long-term growth by introducing innovative products, entering into strategic relationships, expanding into new markets, and providing high quality products with an industry-leading 5-year warranty. In fiscal year 2009, we plan to continue to build on this foundation and to execute well in key areas, including continuing to innovate using existing and new technologies, to build and maintain key relationships in the sales distribution channels, to improve sales force productivity, to deliver high quality products, and to manage expenses.

Key opportunities include the following:

Product Innovation Our products provide exceptional reliability, image quality, and ease of use in a lightweight design that can be either hand-carried, used on a stand or mounted on a wall or from a ceiling. We are committed to continuing to develop our next generation of products and expanding our existing product base by using new and existing technologies. Fiscal year 2008 saw a broad adoption of the M-Turbo and S Series ultrasound tools that were introduced at the end of 2007 and during 2008.

Strategic Relationships We are focused on building relationships that will enable us to continue to develop markets within ultrasound or with ultrasound-dependent technologies. We believe that these relationships can accelerate market penetration to customers not served by our direct sales force.

Acquisitions We intend to continue exploring the possible acquisition of one or more medical device companies in an effort to expand our product portfolio and our sales channels, create international operating leverage, improve marketing and other efficiencies, and leverage manufacturing and supply chain economics.

Results of Operations

Our financial performance during 2008 reflected an increase in revenue, operating income, and cash flow. The introduction of M-Turbo® and S Series™ product lines in late 2007 provided strong revenue growth. We were able to demonstrate operating leverage despite the challenging worldwide economy.

Revenue

Revenue increased to $243.5 million in 2008, compared to $205.1 million in 2007 and $171.1 million in 2006. The increase in 2008 compared to 2007 was attributable to the full year of sales of M-Turbo systems, which has a higher average selling price than the MicroMaxx system, and S Series ultrasound tools; expansion of

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our international sales channels; improved U.S. sales productivity; offset by a reduction in sales of earlier products. The increase in 2007 compared to 2006 was due to the introduction of new products in the fourth quarter of 2007 and increased sales of MicroMaxx systems offset by a reduction in sales of earlier products. Changes in exchange rates had a 1% positive impact on revenue in 2008 and had a 2% positive impact on revenue in 2007.

United States

U.S. revenue increased to $116.7 million in 2008, compared to $104.1 million in 2007 and $89.7 million in 2006. The increase in 2008 compared to 2007 was attributable to increased sales of new products and increased sales productivity. The increase in 2007 compared to 2006 was primarily attributable to increased sales in both hospitals and office channels.

International

Revenue from Europe, Africa and the Middle East increased to $72.2 million in 2008, compared to $59.0 million in 2007 and $48.9 million in 2006. The increase in 2008 compared to 2007 was primarily due to new products and expansion of our sales channel, partially offset by an unfavorable exchange impact of 0.5%. The increase in 2007 compared to 2006 was primarily due to an increase in revenue from direct sales in the UK, France and Spain offset by decreases in direct sales to Italy, which became a direct sales subsidiary in September 2007, and in Germany.

Revenue from Latin America and Canada increased to $24.5 million in 2008 compared to $17.8 million in 2007 and $12.3 million in 2006. The increase in 2008 compared to 2007 was due to increased sales in Latin America attributable to expansion of the sales channel, partially offset by an unfavorable exchange impact of 1.3%. The increase in 2007 compared to 2006 was due to a significant increase in Canada due to the sales force expansion and expansion of the dealer network in Latin America.

Revenue from Asia Pacific increased to $30.1 million in 2008 compared to $24.2 million in 2007 and $20.2 million in 2006. The increase in 2008 compared to 2007 was due to increased sales in Australia attributable to new products and a favorable exchange impact of 7.0%. The increase in 2007 compared to 2006 was primarily due to the expansion of the sales force.

Fiscal Year 2009 Outlook

Given the turmoil in the global economy, we are unable to predict whether our revenues will increase in 2009 compared to 2008. We expect to introduce new products and features, to develop the U.S. physicians office market, and to expand our international operations. The expansion of our international markets, as well as the development of the U.S. hospital and physician office markets, considering current economic conditions, may not be as successful as anticipated and we may encounter regulatory and other issues in selling our products. Our revenue may also be 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 remained at 70% in 2008 compared to 70% in 2007 and 71% in 2006. Gross margin remained consistent in 2008 compared to 2007 primarily as a result of the increase in warranty expense, resulting from a shift to products with five year warranties from products with one year warranties, which was offset by the reduction in royalties to ATL, which had expired in September 2007, reduction of material costs, and, favorable impact of foreign exchange rates. The decrease in 2007 compared to 2006 was impacted negatively from the increased sales to our distributor network and transitioning of sales from MicroMaxx to the new products, offset by the reduction in royalties to ATL and the positive impact of foreign exchange rates.

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Fiscal Year 2009 Outlook

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

Operating expenses

Research and development expenses increased to $28.7 million in 2008 compared to $25.9 million in 2007 and $20.2 million in 2006. The increase in 2008 compared to 2007 was due to development of future new products and features, and further development related to the M-Turbo system and S Series ultrasound tools. The increase in 2007 compared to 2006 was due to increased headcount for development of the M-Turbo system and S Series ultrasound tools, which were released in 2007, and for future new products and features.

Sales, general and administrative expenses increased to $118.7 million in 2008 compared to $112.2 million in 2007 and $97.4 million in 2006. The increase in 2008 compared to 2007 was attributable to increased headcount to support business growth, increased incentive compensation related to improved financial performance, increased stock-based compensation, increased legal costs related to our patent litigation, increased severance and acquisition costs, and the elimination of overhead within the company s marketing, general and administrative structure. The increase in 2007 compared to 2006 was attributable to the expansion of international sales operations, continued growth in the office by our sales channel partner, increased efforts in education and training, and increased legal costs related to our patent litigation.

Fiscal Year 2009 Outlook

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

Other income, net

Total other income was $11.7 million in 2008, compared to $6.6 million in 2007 and $4.0 million in 2006. The increase in 2008 compared to 2007 was primarily attributable to the gain recognized on the partial repurchase of our convertible senior notes during the fourth quarter; partially offset by a decrease in interest income, resulting from lower interest rates; higher interest expense, resulting from the first full year of outstanding convertible debt; and foreign currency losses. The increase in 2007 compared to 2006 was due to increased interest income, resulting from higher cash and investment balances, and higher foreign currency gains, offset by interest expense from our convertible senior notes.

Fiscal Year 2009 Outlook

We anticipate that other income will decrease in 2009 as we do not expect to repurchase the same amount of convertible senior notes and will incur additional interest expense as a result of the adoption of FSP No. APB 14-1. See *Recent Accounting Pronouncements* for additional discussion on the adoption of FSP No. APB 14-1.

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Income tax expense

Income tax expense was $13.5 million in 2008, $4.1 million in 2007, and $0.6 million in 2006. Due to our profitable operations in 2008, 2007 and 2006, we recorded income tax expense for financial reporting purposes and accordingly reflected changes in our deferred tax assets. The income tax expense is based on a blended federal and state rate applied to U.S. income and the applicable foreign rates applied to foreign income. The increase in our consolidated effective tax rate in 2008, as compared to 2007, results primarily from non-deductible expense associated with a contingent liability incurred as part of the LumenVu acquisition, a tax assessment resulting from an income tax audit in a non-U.S. jurisdiction, an increase in executive compensation subject to Internal Revenue Code Section 162(m) limitations and the impact of reaching the maximum federal marginal tax rate. In 2008 we utilized our net operating losses (NOLs) and alternative minimum tax credits carried forward from 2007 and a portion of research and development tax credits. Foreign NOLs will be utilized in jurisdictions where they are available and cash will be paid in jurisdictions that do not have foreign NOLs. During the fourth quarter of 2006, we reversed the valuation allowance on deferred tax assets primarily representing net operating losses from our international operations, resulting in a reduction of $1.9 million to our income tax provision. We did not reverse the valuation allowance until it was more likely than not that the tax asset would be realized.

We assess our ability to realize our tax credit carryforwards in future periods and record any resulting adjustments that may be required to deferred income tax expense. In addition, we reduce the deferred income tax asset for the benefits of NOL carryforwards utilized currently as well as the reversing effect of temporary differences. The future impact on net income may therefore be positive or negative, depending on the net result of such adjustments and charges.

Fiscal Year 2009 Outlook

We anticipate that our effective tax rate in 2009 will remain comparable to fiscal year 2008.

Liquidity and Capital Resources

Our cash and cash equivalents balance was $209.3 million as of December 31, 2008, compared to $188.7 million as of December 31, 2007. Cash and cash equivalents are primarily invested in money market accounts. Our short-term and long-term investment securities totaled $70.5 million as of December 31, 2008, compared to $121.1 million as of December 31, 2007. Investment securities generally consist of high-grade U.S. government and corporate debt. 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 December 31, 2008, we had $2.8 million in the Columbia Strategic Cash Portfolio, which is in the process of liquidation. In our judgment this investment, which is classified as a money market account, has experienced a decline in fair value that is other than temporary, accordingly we have recognized an impairment loss of $0.7 million in 2008 and $0.2 million in 2007. Distributions from this portfolio are solely at the discretion of the portfolio manager. We anticipate that $2.2 million will be distributed from this portfolio during 2009, which is recorded as a short-term investment, and $0.6 million will be distributed after 2009, which is recorded as a long-term investment.

Operating activities provided cash of $29.2 million in 2008, compared to cash provided of $16.2 million in 2007 and $10.8 million in 2006. The increase of cash provided in 2008 compared to 2007 was primarily due to improved operations and reduced spending on inventory and prepaid assets, partially offset by a reduction in payables. The comparison of cash provided in 2007 compared to 2006 was primarily due to increases in accrued expenses, offset by increases in accounts receivable and inventories.

Investing activities provided cash of $46.6 million in 2008, compared to $86.1 million used in 2007 and $3.1 million used in 2006. The increase in cash provided in 2008 compared to cash used in 2007 was primarily due to an increase in net proceeds from sales of investment securities of $129.0 million and lower acquisition

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costs of $3.5 million. The increase in cash used in 2007 compared to 2006 was due to the net purchases of investment securities of $78.6 million and our acquisition of LumenVu of $3.5 million.

Financing activities used cash of $56.3 million in 2008, provided $214.6 million in 2007 and provided $12.2 million in 2006. Cash used in financing activities was primarily the result of $68.3 million in repurchases of senior convertible notes and the associated warrant repurchases, partially offset by the sale of call options for $6.4 million and the exercise of stock options and our employee stock purchase plan totaling $4.6 million. This compared to proceeds from the issuance of convertible debt of $217.6 million in 2007, offset by the purchase of the call option intended to partially hedge our convertible note for $28.6 million and issuance of warrants for $19.5 million, and the exercise of stock options and our employee stock purchase plan totaling $5.6 million in 2007 and $10.2 million in 2006.

Fiscal Year 2009 Outlook

We believe that our existing cash and cash generated from operations will be sufficient to fund our operations and planned capital expenditures in 2009. Nevertheless, we may experience an increased need for additional cash in order to complete future acquisitions. Our ability to provide cash from operations will depend on our ability to successfully sell our products, collect our receivables, control our inventories and manage our expenses.

Off-balance sheet arrangements

During the year ended and as of December 31, 2008, we had no off-balance sheet arrangements, other than obligations under our operating leases reflected in the contractual obligations table below. We are not a party to any derivative transactions except for certain foreign exchange rate hedging transactions that we enter into from time to time, discussed more fully under Foreign currency risk in Item 7A below and the call option and warrant instruments indexed to our common stock.

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

Contractual obligations

We have the following contractual obligations as of December 31, 2008:

		Payments due by period			
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
			(in thousands)		
Operating lease obligations	$ 14,342	$ 3,527	$ 5,676	$ 4,439	$ 700
Long-term debt obligations (1)	180,240	5,426	10,852	10,852	153,110
Other long-term obligations (2)	10,022	256	4,543	5,223	
Total Contractual Obligations	$ 204,604	$ 9,209	$ 21,071	$ 20,514	$ 153,810

(1) Includes interest of 3.75% on convertible senior notes
(2) Contingent purchase consideration for the acquisition of LumenVu Inc. The consideration is contingent upon achieving milestones related to the technology acquired from LumenVu.

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In addition to the amounts shown in the table above, we have $3.2 million of unrecognized tax benefits reflected as either liabilities or as a reduction of deferred tax assets, and we are uncertain as to if or when such amounts may be settled.

Other commitments

In June 2008, we committed to donating 12 of our systems and two probes per system per year over a four-year period to a research university. Our contributions to the university will commence in 2010. In 2005, we entered into an agreement to contribute up to $1.0 million to a research university. This pledge, which is to be paid over a four-year period, is conditioned upon our election to make a payment on an annual basis. We expensed $0.3 million in 2008, $0.3 million in 2007 and $0.3 million in 2006 for this arrangement.

As part of our agreements with our suppliers, suppliers may procure resources and material expected to be used for the manufacture of our products in accordance with our production schedule provided to them. We may be responsible for compensating our suppliers for these procurements in the event these items are not used in the quantities submitted as part of the production schedule or material becomes obsolete as a result of production timing, material changes or design changes.

At December 31, 2008 we maintained a deposit of $0.7 million with our bank in the United Kingdom as security for payment of customs and duties charges. This amount is included in other long-term assets.

In the U.S., we have complemented our direct sales efforts by entering into group purchasing agreements with major healthcare group purchasing organizations (GPO). Typically, a GPO negotiates with medical suppliers, such as us, on behalf of the GPO s member healthcare facilities, providing such members with uniform pricing and terms and conditions. In exchange, the GPO identifies us as a preferred supplier for its members. Member facilities participating in the GPO s purchasing program can consist of hospitals, medical group practices, nursing homes, surgery centers, managed care organizations, long term care facilities, clinics and integrated delivery networks. These agreements require us to pay fees based on the amount of sales generated from these agreements. We recorded fees related to these agreements as sales and marketing expenses in the amounts of $2.1 million in 2008, $1.8 million in 2007 and $1.4 million in 2006.

Critical Accounting Policies and Estimates

Our critical accounting policies are discussed in Note 2: *Summary of Significant Accounting Policies* of the Notes to the Consolidated Financial Statements. Our consolidated financial statements and accompanying notes are prepared in accordance with U.S. generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amount 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, 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. Critical accounting policies for us include revenue recognition, valuation of investments and inventories, warranty expense, income taxes, stock-based compensation, and convertible debt.

Revenue recognition. We recognize revenue on products and accessories when goods are shipped under an agreement with a customer, risk of loss and title have passed to the customer, sales returns are estimable and collection of any resulting receivable is reasonably assured. For service contracts, revenue is recognized as services are provided or over the term of the contract. Revenue is recorded net of any discounts, trade-in allowances, and estimated returns. We estimate returns by reviewing our historical returns, considering customer reaction to new product introductions and current economic conditions. We separately price and sell product upgrades to our customers.

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Sales to distributors are generally made pursuant to standard distributor agreements. We recognize revenue when title and risk of loss have transferred to the distributor. Our only significant post-shipment obligation to distributors is our product warranty covering materials and workmanship (see Warranty expense below). The distributor can only reject products for an obvious defect or shipping error, generally within 30 days of receipt, and in such cases, replacement products would be sent. Since the distributor s remedy is the replacement of the product and not a refund or credit, we do not defer revenue associated with these sales. Costs associated with the repair of returned, defective products are captured in our warranty accrual. Our standard distributor arrangements do not have any other return provisions.

Our sales arrangements may contain multiple elements, which include hardware and software products. Revenue from the sale of software, software-related elements, and hardware when the software elements are more than incidental to the product as a whole, is recognized in accordance with software revenue recognition rules. We have vendor specific objective evidence (VSOE) of fair value for our products. Accordingly, for transactions that have undelivered elements for which we have VSOE of the elements, revenue equal to the total fair value of the undelivered elements is deferred and is not recognized until the element is delivered to the customer. When the undelivered element represents services under extended service contracts, revenue equal to the stated price is deferred and recognized evenly over the contract term as those services are provided.

Investments. Our investment securities primarily consist of high-grade U.S. government or corporate debt and high-grade asset-backed securities. We have the ability to hold our securities until maturity, however, we classify all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies. These securities are carried at fair value, with the unrealized gains and losses generally reported as a component of other comprehensive income until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Interest income is recognized when earned.

A decline in market value of any available-for-sale security below cost that is determined to be other than temporary results in a revaluation of its carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. We may incur unrealized losses due to changes in market value attributable to changes in interest rates. Generally we have the ability and intent to hold our investments until a recovery of cost, which may be maturity.

Valuation of 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 to their net realizable values are recorded for obsolete material, shrinkage, earlier generation products and used or refurbished products held either as saleable inventory or as demonstration product.

We make judgments regarding the carrying value of our inventories based on current market conditions. Market conditions may change depending upon competitive product introductions, consumer demand and reimbursement criteria in the medical community. 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.

Warranty expense. We accrue estimated warranty expense at the time of sale for costs expected to be incurred under our product warranties. This provision for warranty expense is made based upon our historical product failure rates and service repair costs using management s judgment. We have limited history with some of our products. We provide, with certain exceptions, a five-year warranty with the MicroMaxx system, M-Turbo system and S Series ultrasound tools. Given the length of the warranty period, the warranty liability for these systems is more difficult to estimate than it has been for our other products that have a one-year warranty. However, given the similarity of the components used in the M-Turbo system and S Series ultrasound tools compared with our MicroMaxx system and the historical product failure rate and service repair costs of the

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MicroMaxx and the other systems, we believe that we can reasonably estimate the amount of the warranty liability for these products. We expect our warranty liability and expense to continue to increase significantly due to the five-year warranty offered with these products. 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.

Income taxes. The process of accounting for income taxes involves calculating our current tax obligation or refund and assessing the nature and measurements of temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences, and our net operating loss (NOL) and credit carryforwards, result in deferred tax assets and liabilities. In each period, we assess the likelihood that our deferred tax assets will be recovered from existing deferred tax liabilities or future taxable income in each jurisdiction. To the extent we believe that we would not meet the test that recovery is more likely than not , we would establish a valuation allowance. To the extent that we establish a valuation allowance or change this allowance in a period, we would adjust our tax provision or tax benefit in the consolidated statement of operations. We use our judgment to determine our provision or benefit for income taxes, including estimates associated with uncertain tax positions and any valuation allowance recorded against our deferred tax assets based on the weight of all positive and negative factors, including cumulative trends in profitability.

The determination of our provision for income taxes requires judgment, the use of estimates, and the interpretation and application of complex tax laws. Judgment is required in assessing the timing and amounts of deductible and taxable items and the probability of sustaining uncertain tax positions. The benefits of uncertain tax positions are recorded in our financial statements only after determining a more-likely-than-not probability that the uncertain tax positions will withstand challenge, if any, from tax authorities. When facts and circumstances change, we reassess these probabilities and record any changes in the financial statements as appropriate.

We have accumulated foreign NOL carryforwards and research and experimentation tax credit carryforwards. In 2008, we utilized our remaining U.S. NOL and alternative minimum tax credit carried forward from 2007 and a portion of our research and experimentation tax credit carryforwards. We assess our ability to utilize our NOL and tax credit carryforwards in future periods and record any resulting adjustments that may be required to deferred income tax expense. In addition, we reduce the deferred income tax asset for the benefits of NOL and tax credit carryforwards utilized currently. The future impact on net income may therefore be positive or negative, depending on the net result of such adjustments and charges.

Based upon a review of historical operating performance, and our expectation that we will generate profits in the U.S. and our international operations in the foreseeable future, we continue to believe it is more likely than not that the U.S. and international deferred tax assets will be fully realized.

Stock-Based Compensation. We recognize compensation expense for awards of equity instruments to employees based on the grant-date fair value of those awards (with limited exceptions). For stock options, we utilize the Black-Scholes option pricing model to estimate the fair value of employee stock-based compensation at the date of grant, which requires the input of subjective assumptions, including expected volatility and expected term. We estimate volatility by considering our historical stock volatility. We estimate expected term based on historical trends. Further, we estimate future forfeitures for both stock options and RSUs granted, which are not expected to vest. We estimate forfeitures using historical forfeiture trends and employee turnover rates as well as our judgment of future forfeitures. Our estimates of forfeitures will be adjusted over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from our estimate.

Changes in these inputs and assumptions can materially affect the measure of estimated fair value of our stock-based compensation. These assumptions are subjective and generally require significant analysis and judgment to develop. When estimating fair value, some of the assumptions will be based on, or determined from, external data and other assumptions may be derived from our historical experience with stock-based payment

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arrangements. The appropriate weight to place on historical experience is a matter of judgment, based on relevant facts and circumstances. In addition, future grants of equity awards will result in additional compensation expense in future periods.

Convertible debt and hedge transaction. We have recorded our senior convertible note as debt. The conversion option met the criteria, in our judgment, to preclude recognition as a debt discount. If the conversion option had been recognized as a debt discount, it would have been recognized as additional interest expense over the term of the notes. Accordingly, our interest expense is based upon the stated rate. Additionally, we recorded the call option and warrant transactions as equity instruments since our judgment is that they met the existing criteria. If the call option and warrant transactions had not met the criteria, then the instruments would have been recorded as assets or liabilities and any changes in the fair values would be recognized in the consolidated income statement.

Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141(R), Business Combinations (SFAS No. 141(R)). SFAS No. 141(R) expands the definition of a business and establishes the use of the acquisition method for business combinations. This method requires all assets and liabilities, including goodwill, of an acquired business to be measured at fair value on the acquisition date. Among other things, the standard requires entities to expense most transaction and restructuring costs; establishes fair value measurement for contingent consideration in earnings; and requires capitalization of in-process research and development. The standard also modifies the recording and presentation of deferred taxes. SFAS No. 141(R) will be applied prospectively to business combinations with acquisition dates on or after January 1, 2009. Our adoption of SFAS No. 141(R) is not expected to materially impact our consolidated financial position, results of operations or liquidity when it becomes effective.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160 (SFAS 160), Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 . SFAS 160 changes the accounting for noncontrolling (minority) interests in consolidated financial statements, including the requirements to classify noncontrolling interests as a component of consolidated stockholders equity, to identify earnings attributable to noncontrolling interests reported as part of consolidated earnings, and to measure gain or loss on the deconsolidated subsidiary based upon the fair value of the noncontrolling equity investment. Additionally, SFAS 160 revises the accounting for both increases and decreases in a parent s controlling ownership interest. SFAS 160 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. We believe that the adoption of SFAS 160 will not have a material effect to its consolidated financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS No. 161). SFAS No. 161 requires enhanced disclosures regarding an entity s derivative and hedging activities. These enhanced disclosures include information regarding how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and its related interpretations; and how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of SFAS No. 161 will not have an impact on our financial position, results of operations or liquidity.

In April 2008, the FASB issued FASB Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets, (FSP 142-3), which provides guidance about estimating the useful lives of recognized intangible assets, and requires additional disclosures related to renewing or extending the terms of recognized intangible assets. FSP 142-3 applies to all recognized intangible assets, including those not acquired in a business

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combination. In estimating the useful life of a recognized intangible asset, FSP 142-3 requires companies to consider their historical experience in renewing or extending similar arrangements together with the asset s intended use, regardless of whether the arrangements have explicit renewal or extension provisions. In the absence of historical experience, companies must consider the assumptions market participants would use about renewal or extension assumptions that are consistent with both the highest and best use of the asset and adjusted for entity-specific factors. FSP 142-3 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The requirements for estimating useful lives must be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements must be applied to all intangible assets recognized as of the effective date. Early adoption is prohibited. We are currently reviewing the provisions of FSP 142-3 to determine the impact on our future consolidated financial statements.

In May 2008, the FASB issued FSP No. APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement) (APB 14-1), which clarifies the accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. APB 14-1 requires issuers to account separately for the liability and equity components of certain convertible debt instruments in a manner that reflects the issuer s nonconvertible debt borrowing rate when interest cost is recognized. APB 14-1 requires bifurcation of a component of the conversion option, classification of that component in equity and the accretion of the resulting discount on the debt to be recognized as part of interest expense in our consolidated statement of income. APB 14-1 requires retrospective application to the terms of instruments as they existed for all periods presented. APB 14-1 is effective as of the first quarter of fiscal years beginning after December 15, 2008 and will be applied retrospectively for all periods presented. Early adoption is not permitted. As a result of adopting APB 14-1 in 2009, we expect to recognize additional non-cash interest expense of $7 million for 2008 and $4 million for 2007.

ITEM 7A. 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 December 31, 2008, our investments consisted of $69.9 million of interest-bearing debt securities with maturities or expected maturities of less than one year and $0.6 million of interest-bearing debt securities with expected maturities of more 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 2009 from a hypothetical 10% increase or decrease 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 foreign subsidiaries, we transact all our sales in USDs; therefore, the obligations of many of our international customers are in USDs. Our exposure to risk from fluctuations in foreign currencies relates primarily 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 ability to collect amounts owed by them.

As of December 31, 2008 66% of our outstanding accounts receivable balance was from international customers, of which 56%, or $24.1 million, was denominated in a currency other than USDs. Total sales for the year ended December 31, 2008 denominated in a currency other than USDs were $78.2 million, or 32% of total consolidated revenues. The British pound, the European Union euro and the Japanese yen represented the

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majority of financial transactions executed in a currency not denominated in USDs. We regularly review our receivable positions in foreign countries for any indication that collection may be at risk. In addition, we utilize letters of credit where they are considered necessary in order to mitigate our collection risk.

We periodically enter into foreign currency forward and participating forward contracts to reduce the impact of adverse fluctuations on earnings associated with foreign currency exchange rate changes. As of December 31, 2008, we had $55.6 million in notional amount of foreign currency contracts that expire on January 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 Australian Dollar, the Canadian Dollar, the British pound, the Euro and the Japanese yen. A sensitivity analysis of a change in the fair value of these contracts indicates that if the USD weakened by 10% against the applicable foreign currency, the fair value of these contracts would decrease by $5.6 million. Conversely, if the USD strengthened by 10% against the applicable foreign currency, the fair value of these contracts would increase by $5.6 million. Gains and losses in the fair value of these contracts are intended to offset the losses and gains on the underlying intercompany balances. These offsetting gains and losses are not reflected in the sensitivity analysis above. The fair value of these contracts as of December 31, 2008 was not material to our results of operations or our financial position.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

SONOSITE, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

SonoSite, Inc.:

We have audited the accompanying consolidated balance sheets of SonoSite, Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, cash flows, and shareholders equity and comprehensive income for each of the years in the three-year period ended December 31, 2008. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule listed in Item 15(a). These consolidated financial statements and the financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and the financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of SonoSite, Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), SonoSite Inc. s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 10, 2009 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP

Seattle, Washington

March 10, 2009

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

SonoSite, Inc.:

We have audited SonoSite Inc. s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying management s report on internal control over financial reporting (Item 9A(b)). Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, SonoSite, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of SonoSite, Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, cash flows, and shareholders equity and comprehensive income for each of the years in the three-year period ended December 31, 2008, and our report dated March 10, 2009 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Seattle, Washington

March 10, 2009

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SONOSITE, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	As of December 31, 2008	2007
ASSETS		
Current Assets		
Cash and cash equivalents	$ 209,258	$ 188,701
Short-term investment securities	69,882	119,873
Accounts receivable, less allowances of $2,190 and $957	66,094	60,954
Inventories	29,115	29,740
Deferred income taxes, current	9,355	13,023
Prepaid expenses and other current assets	6,623	7,759
Total current assets	390,327	420,050
Property and equipment, net	8,955	10,133
Investment securities	578	1,257
Deferred income taxes, net	6,134	8,431
Goodwill	3,767	3,416
Identifiable intangible assets, net	13,062	12,930
Other assets	6,464	9,521
Total assets	$ 429,287	$ 465,738
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 6,189	$ 8,868
Accrued expenses	31,921	24,431
Deferred revenue, current portion	2,755	3,502
Total current liabilities	40,865	36,801
Long-term debt	144,745	225,000
Other non-current liabilities	13,750	11,075
Total liabilities	199,360	272,876
Commitments and contingencies		
Shareholders Equity		
Preferred stock, $1.00 par value Authorized shares 6,000,000 Issued and outstanding shares none		
Common stock, $0.01 par value Shares authorized 50,000,000 Issued and outstanding shares:		
As of December 31, 2008 17,054,697		
As of December 31, 2007 16,746,017	171	167
Treasury stock	(133)	(133)
Additional paid-in capital	253,028	236,291
Accumulated deficit	(24,307)	(44,893)
Accumulated other comprehensive income	1,168	1,430
Total shareholders equity	229,927	192,862
Total liabilities and shareholders equity	$ 429,287	$ 465,738

See accompanying notes to the consolidated financial statements.

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SONOSITE, INC.

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

	For the Years Ended December 31,		
	2008	2007	2006
Revenue	$ 243,524	$ 205,068	$ 171,083
Cost of revenue	73,715	62,505	49,673
Gross margin	169,809	142,563	121,410
Operating expenses:			
Research and development	28,698	25,872	20,183
Sales, general and administrative	118,679	112,240	97,391
Total operating expenses	147,377	138,112	117,574
Other income and expense:			
Interest income	9,089	9,662	3,683
Interest expense	(9,009)	(4,371)	
Gain on convertible note repurchase	15,684		
Other	(4,113)	1,274	294
Total other income, net	11,651	6,565	3,977
Income before income taxes	34,083	11,016	7,813
Income tax provision	13,497	4,132	582
Net income	$ 20,586	$ 6,884	$ 7,231
Net income per share:			
Basic	$ 1.22	$ 0.41	$ 0.44
Diluted	$ 1.18	$ 0.40	$ 0.43
Weighted average common and potential common shares outstanding:			
Basic	16,892	16,621	16,274
Diluted	17,486	17,168	16,857

See accompanying notes to the consolidated financial statements.

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SONOSITE, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	For the Years Ended December 31,		
	2008	**2007**	**2006**
Operating activities:			
Net income	$ 20,586	$ 6,884	$ 7,231
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	4,125	4,290	3,118
Stock-based compensation	8,709	6,809	7,328
Deferred income tax provision	8,929	1,933	220
Amortization of net premiums (discounts) on investment securities	(169)	(1,043)	(386)
Amortization of debt issuance costs	1,001	520	
Accretion of contingent purchase consideration	900	330	
Excess tax benefit from stock-based compensation	(1,025)	(630)	(2,006)
Loss on sale of property and equipment			49
Net loss (gain) on investments	47	10	(5)
Investment other-than-temporary impairment	720	160	
Gain on convertible note repurchase	(15,684)		
Gain on legal settlements	(643)		
Changes in operating assets and liabilities:			
Accounts receivable	(6,273)	(6,994)	(9,400)
Inventories	194	(6,210)	(1,866)
Prepaid expenses and other assets	1,391	(2,210)	(593)
Accounts payable	(2,624)	3,009	2,289
Accrued expenses	10,014	8,939	3,237
Deferred liabilities	(1,027)	429	1,574
Net cash provided by operating activities	29,171	16,226	10,790
Investing activities:			
Purchase of investment securities	(248,124)	(418,417)	(93,963)
Proceeds from sales/maturities of investment securities	298,514	339,806	97,091
Purchase of property and equipment	(2,841)	(3,341)	(5,521)
Proceeds from sale of property and equipment			75
Purchase of LumenVu, Inc.		(3,498)	
Earn-out consideration for SonoMetric Health, Inc.	(921)	(654)	(797)
Net cash provided by (used in) investing activities	46,628	(86,104)	(3,115)
Financing activities:			
Excess tax benefit from stock-based compensation	1,025	630	2,006
Purchase of treasury stock		(133)	
Proceeds from exercise of stock options and employee stock purchase plan	4,551	5,597	10,161
Proceeds from issuance of convertible senior notes, net		217,606	
Repurchase of convertible debt	(62,406)		
Purchase of call options		(28,612)	
Proceeds from sale of call options	6,417		
Proceeds from issuance of warrants		19,546	
Purchase of warrants	(5,934)		
Net cash (used in) provided by financing activities	(56,347)	214,634	12,167
Effect of exchange rate changes on cash and cash equivalents	1,105	(1,728)	(978)
Net change in cash and cash equivalents	20,557	143,028	18,864
Cash and cash equivalents at beginning of year	188,701	45,673	26,809

Cash and cash equivalents at end of year	$ 209,258	$ 188,701	$ 45,673
Supplemental disclosure of cash flow information:			
Cash paid for income taxes	$ 2,777	$ 1,182	$ 102
Cash paid for interest	$ 9,323	$	$

See accompanying notes to the consolidated financial statements.

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SONOSITE, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

AND COMPREHENSIVE INCOME

(in thousands, except shares)

	Common Stock		Treasury Stock						
	Shares	Amount	Shares	Amount	Additional paid-in capital	Deferred stock compensation	Accumulated deficit	Accumulated other comprehensive income	Total shareholders equity
Balance at December 31, 2005	15,872,078	$ 159		$	$ 212,709	$ (2,671)	$ (59,008)	$ 853	$ 152,042
Comprehensive income:									
Net income							7,231		7,231
Net unrealized gain on investment securities, net of tax of $75								115	115
Less reclassification adjustment for loss included in net income								(5)	(5)
Foreign currency translation adjustment								294	294
Comprehensive income									7,635
Effect of adoption of SFAS 123R					(2,671)	2,671			
Exercise of stock options and employee stock purchase plan	569,099	5			10,156				10,161
Tax benefit from exercise of stock options					3,828				3,828
Stock-based compensation					7,365				7,365
Balance at December 31, 2006	16,441,177	164			231,387		(51,777)	1,257	181,031
Comprehensive income:									
Net income							6,884		6,884
Net unrealized gain on investment securities, net of tax of $77								141	141
Less reclassification adjustment for gain included in net income								(10)	(10)
Foreign currency translation adjustment								42	42
Comprehensive income									7,057
Treasury stock			(4,560)	(133)					(133)
Exercise of stock options and employee stock purchase plan	309,400	3			5,594				5,597
Tax benefit from exercise of stock options					999				999
Tax benefit related to original issue discount on the convertible senior notes					573				573
Stock-based compensation					6,804				6,804
Purchase of convertible bond call option					(28,612)				(28,612)
Proceeds from issuance of warrants					19,546				19,546
Balance at December 31, 2007	16,750,577	167	(4,560)	(133)	236,291		(44,893)	1,430	192,862

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SONOSITE, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

AND COMPREHENSIVE INCOME

(in thousands, except shares)

(continued)

	Common Stock		Treasury Stock						
	Shares	Amount	Shares	Amount	Additional paid-in capital	Deferred stock compensation	Accumulated deficit	Accumulated other comprehensive income	Total shareholders equity
Comprehensive income:									
Net income							20,586		20,586
Net unrealized gain on investment securities, net of tax of $118								248	248
Less reclassification adjustment for gain included in net income								(47)	(47)
Foreign currency translation adjustment								(463)	(463)
Comprehensive income									20,324
Exercise of stock options and employee stock purchase plan	260,254	3			4,548				4,551
Tax benefit from stock-based compensation					865				865
Tax benefit related to original issue discount on the convertible senior notes					1,231				1,231
Tax benefit related to cancelation of debt					1,369				1,369
Stock-based compensation					8,676				8,676
Restricted stock units vested, net of 13,574 shares retired	48,426	1			(435)				(434)
Sale of call option					6,417				6,417
Repurchase of warrants					(5,934)				(5,934)
Balance at December 31, 2008	17,059,257	$ 171	(4,560)	$ (133)	$ 253,028	$	$ (24,307)	$ 1,168	$ 229,927

See accompanying notes to the consolidated financial statements.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Business Overview

SonoSite develops, manufactures, and distributes hand-carried ultrasound systems for use across medical specialties and in a range of treatment settings.

We commenced operations as a division of ATL Ultrasound, Inc. (ATL). On April 6, 1998, we became an independent, publicly owned company through a distribution of one new share of our stock for every three shares of ATL stock held as of that date. ATL retained no ownership in SonoSite following the spin-off.

2. Summary of Significant Accounting Policies

Basis of presentation and use of estimates

The consolidated financial statements are prepared in conformity with U.S. generally accepted accounting principles. The consolidated financial statements include the accounts of SonoSite, Inc., and our wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. In preparing the consolidated financial statements, management must make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassification of prior period balances

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

Cash and cash equivalents

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

Investment securities primarily consist of high-grade U.S. government or corporate debt and high-grade asset-backed securities. We have the ability to hold our securities until maturity; however, we classify all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis.

A decline in market value of any available-for-sale security below cost that is determined to be other than temporary results in a revaluation of its carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Interest income is recognized when earned. We may incur unrealized losses due to changes in market value attributable to changes in interest rates. We have the ability and intent to hold our investments until a recovery of cost, which may be maturity.

Accounts receivable

In the ordinary course of business, we grant credit to a broad customer base. Of the accounts receivable balance at December 31, 2008, 66% and 34% were receivable from international and domestic customers, prior to any allowance for doubtful accounts. The same percentages as of December 31, 2007 were 60% and 40% prior to any allowance for doubtful accounts.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

We maintain allowances for estimated losses resulting from the inability of our customers to make required payments. When we determine that amounts owed from customers are uncollectible, such amounts are charged off against the allowances for doubtful accounts. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Fair value of financial instruments

The carrying value of our financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and certain long-term other assets, approximates fair value. Cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to their short-term nature. Financial instruments included in other long-term assets approximate fair value as interest rates on these items approximate market. Our investment securities, which primarily consist of high-grade debt securities, are carried at fair value.

We utilize foreign currency forward contracts to reduce our exposure to foreign currency risk due to fluctuations in exchange rates underlying the value of intercompany accounts receivable denominated in foreign currencies. These contracts did not qualify for hedge accounting and accordingly are marked-to-market with changes in fair value recorded in non-operating income.

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.

Property and equipment

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

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

Asset	Estimated Useful Lives
Equipment and computers	3 5 years
Software	3 years
Furniture and fixtures	5 years
Leasehold improvements	Lesser of estimated useful life or remaining lease term

The carrying value of long-lived asset groups is evaluated for impairment when events or changes in circumstances occur that may indicate the carrying amount of the asset group may not be recoverable. For depreciable property and equipment and amortizable intangible assets, we evaluate the carrying value of the asset group by comparing the estimated future undiscounted cash flows generated from the use of the asset group and

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

its eventual disposition with the asset group s net book value. If the estimated future undiscounted cash flows from an asset group are less than the net book value of the asset group, we record an impairment loss equal to the excess of the net book value over the estimated fair market value of the asset group.

Goodwill and other intangible assets

We perform goodwill impairment tests annually in the fourth quarter of each year, and more frequently if facts and circumstances indicate reporting unit carrying values exceed estimated reporting unit fair values. Intangibles subject to amortization, which consist mainly of acquired technology and non-compete agreements, are amortized using the straight-line method over their estimated useful lives of three to seven years. Indefinite-lived intangible assets are tested for impairment annually, and more frequently if facts and circumstances indicate that the asset might be impaired.

Concentration of credit and supply risk

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

We depend on some single-source suppliers to provide highly specialized parts and other components, and may experience an interruption of supply if a supplier is unable or unwilling to meet our time, quantity and quality requirements.

There are relatively few alternative sources of supply for some of these items. A change in demand for some parts by other companies in our industry could also interrupt our supply of components.

Our circuit boards are produced by one of the world s largest electronic manufacturing services suppliers who produce the boards in their Thailand manufacturing facility. If we experience delays in the receipt or a deterioration in product yields of these components, we may experience delays in manufacturing or an increase in costs resulting in lost sales or a deterioration in gross margin.

Revenue recognition

We recognize revenue on products and accessories when goods are shipped under an agreement with a customer, risk of loss and title have passed to the customer, sales returns are estimable and collection of any resulting receivable is reasonably assured. For service contracts, revenue is recognized as services are provided or over the term of the contract. Revenue is recorded net of any discounts, trade-in allowances, and estimated returns. We estimate returns by reviewing our historical returns, considering customer reaction to new product introductions and current economic conditions. We make product upgrades available for purchase to our customers.

Sales to distributors are generally made pursuant to standard distributor agreements. We recognize revenue when risk of loss and title have transferred to the distributor and collection of any resulting receivable is reasonably assured. Our only significant post-shipment obligation to distributors is our product warranty covering materials and workmanship. The distributor can only reject products for an obvious defect or shipping error, generally within 30 days of receipt, and in such cases, replacement products would be sent. Since the distributor s remedy is the replacement of the product and not a refund or credit, we do not defer revenue associated with these sales. Costs associated with the repair of returned, defective products are captured in our warranty accrual. Our standard distributor arrangements do not have any other return provisions.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

Our sales arrangements may contain multiple elements, which include hardware and software products. Revenue from the sale of software, software-related elements, and hardware when the software elements are more than incidental to the product as a whole, is recognized in accordance with software revenue recognition rules. We have vendor specific objective evidence (VSOE) of fair value for our products. Accordingly, for transactions that have undelivered elements for which we have VSOE of the elements, revenue equal to the total fair value of the undelivered elements is deferred and is not recognized until the element is delivered to the customer. When the undelivered element represents services under extended service contracts, revenue equal to the stated price is deferred and recognized evenly over the contract term as those services are provided.

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. Our warranty period is five years for the MicroMaxx system, M-Turbo system and S Series ultrasound tools, with certain exceptions. Our warranty period for our other products is one year. The warranty is included with the original purchase. In addition to a standard warranty, we offer extended warranty and service agreements for coverage beyond the standard warranty period or coverage above what is covered by a standard warranty. Those service agreements are recorded as deferred revenue.

Research and development

Research and development costs are expensed as incurred with the exception of equipment acquired for research and development activities that has alternative future uses. We have determined that technological feasibility for our software-related products is reached shortly before the products are released to manufacturing. Costs incurred after technological feasibility is established are not material, and accordingly, we expense all software-related research and development costs when incurred.

Advertising costs

We expense costs for advertising and promotional activities as incurred. Advertising and promotional expenses for the years ended December 31, 2008, 2007 and 2006 were $9.4 million, $10.2 million, and $11.7 million.

Income taxes

Deferred income taxes are provided based on the estimated future tax effects of temporary differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards arising since our inception.

Deferred tax assets and liabilities are measured using enacted tax rates that are expected to apply to taxable income in the years in which those temporary differences and carryforwards are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is established when necessary to reduce deferred tax assets to the amount, if any, expected to be realized.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

The determination of our provision for income taxes requires judgment, the use of estimates, and the interpretation and application of complex tax laws. Judgment is required in assessing the timing and amounts of deductible and taxable items and the probability of sustaining uncertain tax positions. The benefits of uncertain tax positions are recorded in our financial statements only after determining a more-likely-than-not probability that the uncertain tax positions will withstand challenge, if any, from tax authorities. When facts and circumstances change, we reassess these probabilities and record any changes in the financial statements as appropriate.

Stock-based compensation

We recognize compensation expense for awards of equity instruments to employees based on the grant-date fair value of those awards. For stock options, we utilize the Black-Scholes option pricing model to estimate the fair value of employee stock-based compensation at the date of grant, which requires the input of subjective assumptions, including expected volatility, expected life, and expected term. We estimate volatility by considering our historical stock volatility. We estimate expected term based on historical trends. Further, we estimate future forfeitures for both stock options and restricted stock units granted, which are not expected to vest. We estimate forfeitures using historical forfeiture trends, employee turnover rates as well as our judgment of future forfeitures. Our estimates of forfeitures will be adjusted over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from our estimate.

Net income per share

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

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

	Year Ended December 31,		
	2008	2007	2006
Net income	$ 20,586	$ 6,884	$ 7,231
Weighted average common shares outstanding used in computing basic net income per share	16,892	16,621	16,274
Effect of dilutive stock options and restricted stock units	594	547	583
Weighted average common and potential common shares outstanding used in computing diluted net income per share	17,486	17,168	16,857
Net income per share:			
Basic	$ 1.22	$ 0.41	$ 0.44
Diluted	$ 1.18	$ 0.40	$ 0.43

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

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

	Year Ended December 31,		
	2008	**2007**	**2006**
Stock options and restricted stock	608	462	344
Warrants outstanding (1)	1,497	2,500	
Total common shares excluded from diluted net income per share	2,105	2,962	344

(1) As further detailed in note 10, Convertible senior notes, in July 2007 we issued warrants to purchase up to 2.5 million shares of our common stock with a strike price of $46.965, which are anti-dilutive since the strike price of the warrants is greater than the market price of our common stock. In 2008, we repurchased warrants that were for the purchase of up to 1.0 million shares.

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

Accumulated other comprehensive income

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

The following are the components of accumulated other comprehensive income at December 31 (in thousands):

	2008	**2007**	**2006**
Net unrealized gain (loss) on investments, net of tax	$ 118	$ (83)	$ (214)
Cumulative translation adjustments	1,050	1,513	1,471
Total accumulated other comprehensive income	$ 1,168	$ 1,430	$ 1,257

Foreign currency translation

The functional currencies of our international subsidiaries, consisting primarily of the British pound, the European Union euro and the Japanese yen, are the local currency of the country in which the subsidiary is located. Assets and liabilities denominated in foreign currencies are translated at the exchange rate on the balance sheet date. Revenues, costs and expenses and cash flows of international operations are translated at average rates of exchange prevailing during the period.

Recent accounting pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141(R), Business Combinations (SFAS No. 141(R)). SFAS No. 141(R) expands the definition of a business and establishes the use of the acquisition method for business combinations. This method requires all assets and liabilities, including goodwill, of an acquired business to be measured at fair value

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

on the acquisition date. Among other things, the standard requires entities to expense most transaction and restructuring costs; establishes fair value measurement for contingent consideration in earnings; and requires capitalization of in-process research and development. The standard also modifies the recording and presentation of deferred taxes. SFAS No. 141(R) will be applied prospectively to business combinations with acquisition dates on or after January 1, 2009. Our adoption of SFAS No. 141(R) is not expected to materially impact our consolidated financial position, results of operations or liquidity when it becomes effective. Subsequent to our adoption of SFAS No. 141(R), the resolution of existing balances related to uncertain tax positions from prior acquisitions that differ from previously recorded amounts will be adjusted through earnings.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160 (SFAS 160), Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 . SFAS 160 changes the accounting for noncontrolling (minority) interests in consolidated financial statements, including the requirements to classify noncontrolling interests as a component of consolidated stockholders equity, to identify earnings attributable to noncontrolling interests reported as part of consolidated earnings, and to measure gain or loss on the deconsolidated subsidiary based upon the fair value of the noncontrolling equity investment. Additionally, SFAS 160 revises the accounting for both increases and decreases in a parent s controlling ownership interest. SFAS 160 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. We believe that the adoption of SFAS 160 will not have a material effect to its consolidated financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS No. 161). SFAS No. 161 requires enhanced disclosures regarding an entity s derivative and hedging activities. These enhanced disclosures include information regarding how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and its related interpretations; and how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of SFAS No. 161 will not have an impact on our financial position, results of operations or liquidity.

In April 2008, the FASB issued FASB Staff Position No. 142-3, Determination of the Useful Life of Intangible Assets, (FSP 142-3), which provides guidance about estimating the useful lives of recognized intangible assets, and requires additional disclosures related to renewing or extending the terms of recognized intangible assets. FSP 142-3 applies to all recognized intangible assets, including those not acquired in a business combination. In estimating the useful life of a recognized intangible asset, FSP 142-3 requires companies to consider their historical experience in renewing or extending similar arrangements together with the asset s intended use, regardless of whether the arrangements have explicit renewal or extension provisions. In the absence of historical experience, companies must consider the assumptions market participants would use about renewal or extension assumptions that are consistent with both the highest and best use of the asset and adjusted for entity-specific factors. FSP 142-3 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The requirements for estimating useful lives must be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements must be applied to all intangible assets recognized as of the effective date. Early adoption is prohibited. We are currently reviewing the provisions of FSP 142-3 to determine the impact on our future consolidated financial statements.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

In May 2008, the FASB issued FSP No. APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement) (APB 14-1), which clarifies the accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. APB 14-1 requires issuers to account separately for the liability and equity components of certain convertible debt instruments in a manner that reflects the issuer s nonconvertible debt borrowing rate when interest cost is recognized. APB 14-1 requires bifurcation of a component of the conversion option, classification of that component in equity and the accretion of the resulting discount on the debt to be recognized as part of interest expense in our consolidated statement of income. APB 14-1 requires retrospective application to the terms of instruments as they existed for all periods presented. APB 14-1 is effective as of the first quarter of fiscal years beginning after December 15, 2008 and will be applied retrospectively for all periods presented. Early adoption is not permitted. As a result of adopting APB 14-1 in 2009, we expect to recognize additional non-cash interest expense of approximately $7 million for 2008 and approximately $4 million for 2007

3. Technology Transfer and License Agreement with ATL

We license ultrasound technology from ATL under a Technology Transfer and License Agreement executed at the time of our spin-off as a public company in 1998. Under that agreement, we took ownership of certain ultrasound technology developed as part of a government grant and also patent rights, which had been established or were being pursued for that technology. As part of this agreement, we also entered into a cross-license whereby we had the exclusive right to use certain ATL technology existing on April 6, 1998 or developed by ATL during the three-year period following April 6, 1998 in ultrasound systems weighing 15 pounds or less, and ATL had the exclusive right to use our technology existing on April 6, 1998 or developed by us during the same three-year period in ultrasound systems weighing more than 15 pounds. On April 6, 2003, this cross-license became nonexclusive and, except for the patented technology of each party, now extends to all ultrasound systems regardless of weight.

Our license from ATL had a royalty equivalent to a percentage of the net sales of ultrasound products under fifteen pounds that use ATL technology, until the royalty payments expired on September 21, 2007. For the years ended December 31, 2007 and 2006, we incurred a royalty expense to ATL of $1.5 million and $2.2 million, which is included in cost of revenue. There was no royalty expense to ATL in 2008.

4. Cash, cash equivalents and investment securities

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

	As of December 31,	
	2008	**2007**
Cash	$ 13,921	$ 13,478
Cash equivalents:		
U.S. Government and agencies		54,683
Corporate bonds	59,947	109,255
Money market accounts	135,390	11,285
Total cash and cash equivalents	$ 209,258	$ 188,701
Investment securities:		
Short-term	$ 69,882	$ 119,873

Long-term	$ 578	$ 1,257

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Cash, cash equivalents and investment securities (Continued)

As of December 31, 2008 and 2007, we had $2.8 million and $12.6 million invested in Columbia Strategic Cash Portfolio, which is in the process of liquidation. In our judgment this investment, which is classified as a money market account, has experienced a decline in fair value that is other than temporary, accordingly we have recognized an impairment loss in 2008 of $0.7 million and in 2007 of $0.2 million. Distributions from this portfolio are solely at the discretion of the portfolio manager. We anticipate that $2.2 million will be distributed from this portfolio during 2009, which is recorded as a short-term investment and $0.6 million will be distributed after 2009, which is recorded as a long-term investment. All other investments will mature in 2009.

The amortized cost, gross unrealized holding gains and losses and fair value of investment securities classified as available-for-sale securities as of December 31 were as follows (in thousands):

	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
2008:				
Cash equivalents:				
Corporate bonds	$ 59,829	$ 118	$	$ 59,947
Money market accounts	135,390			135,390
Total cash equivalents	$ 195,219	$ 118	$	$ 195,337
Short-term:				
Corporate bonds	$ 67,129	$ 234	$	$ 67,363
Money market accounts	2,187			2,187
Asset-backed securities	334		(2)	332
Total short-term investments	$ 69,650	$ 234	$ (2)	$ 69,882
Long-term:				
Money market accounts	$ 578	$	$	$ 578
Total long-term investments	$ 578	$	$	$ 578
2007:				
Cash equivalents:				
U.S. Government and agencies	$ 54,667	$ 16	$	$ 54,683
Corporate bonds	109,248	16	(9)	109,255
Money market accounts	11,285			11,285
Total cash equivalents	$ 175,200	$ 32	$ (9)	$ 175,223
Short-term:				
U.S. Government and agencies	$ 22,382	$ 9	$	$ 22,391

Corporate bonds	82,793	17	(3)	82,807
Money market accounts	11,317			11,317
Asset-backed securities	3,373		(15)	3,358
Total short-term investments	$ 119,865	$ 26	$ (18)	$ 119,873
Long-term:				
Money market accounts	$ 1,257	$	$	$ 1,257
Total long-term investments	$ 1,257	$	$	$ 1,257

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Cash, cash equivalents and investment securities (Continued)

The following table summarizes our realized gains and losses on sales of investments for the years ended December 31 (in thousands):

	2008	2007	2006
Gains	$ 12	$ 8	$ 18
Losses	(59)	(18)	(13)
Realized gain (loss), net	$ (47)	$ (10)	$ 5

Short-term and long-term investments with unrealized losses as of December 31, 2008, consisted of the following (in thousands):

	Gross Unrealized Holding Losses	Fair Value
Loss position for more than 12 months:		
Asset-backed securities	$ 2	$ 332

The gross unrealized losses of $2,000 on two securities as of December 31, 2008 and $27,000 on 17 securities as of December 31, 2007, were primarily caused by changes in interest rates. In 2008, a $0.7 million loss was recognized as an other-than-temporary impairment. In 2007, a $0.2 million loss was recognized as an other-than-temporary impairment and no loss was recognized for other-than-temporary impairments during 2006.

5. Fair Value Measurements

Effective January 1, 2008, we adopted SFAS 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 clarifies the definition of fair value, prescribes methods for measuring fair value, establishes a fair value hierarchy based on the inputs used to measure fair value and expands disclosures about the use of fair value measurements. In accordance with FASB Staff Position (FSP) No. FAS 157-2, *Effective Date of FASB Statement No. 157*, we will defer the adoption of SFAS No. 157 for our nonfinancial assets and nonfinancial liabilities until January 1, 2009. The adoption of SFAS 157 did not have a material impact on our fair value measurements. We do not believe the adoption of SFAS 157 for non-financial assets and liabilities will have a significant impact on our future consolidated financial statements. Fair value measurements consisted of the following:

		Fair Value Measurements		
	Total Carrying Value	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Investment securities	$ 70,460	$ 67,695	$	$ 2,765
Long-term debt	$ 144,745	$ 103,131	$	$

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

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Fair Value Measurements (Continued)

The following table summarizes the 2008 activity of our level 3 investment securities:

Fair value measurements of Level 3 investments

	Year Ended December 31, 2008
Balance, at beginning of period	$ 12,574
Total losses (realized or unrealized):	
Included in other income (loss)	(767)
Sales and settlements	(9,042)
Balance, December 31, 2008	$ 2,765
Losses included in other income (loss) attributable to the change in unrealized losses relating to assets still held	$ (538)

6. Financial statement detail as of December 31, 2008 and 2007

Inventories consisted of the following (in thousands):

	2008	2007
Raw material	$ 10,007	$ 10,710
Demonstration inventory	8,198	7,601
Finished goods	10,910	11,429
Total inventories	$ 29,115	$ 29,740

Property and equipment consisted of the following (in thousands):

	2008	2007
Equipment, other than computer	$ 16,089	$ 14,304
Software	6,661	7,089
Computer equipment	4,751	4,906
Furniture and fixtures	3,210	3,170
Leasehold improvements	3,554	3,512
	34,265	32,981
Less accumulated depreciation and amortization	(25,310)	(22,848)

Total property and equipment, net	$ 8,955	$ 10,133

Depreciation expense for the years ended December 31, 2008, 2007, and 2006 was $4.0 million, $4.0 million and $2.7 million.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Financial statement detail as of December 31, 2008 and 2007 (Continued)

Accrued expenses consisted of the following (in thousands):

	2008	2007
Payroll and related	$ 14,100	$ 10,024
Taxes	3,634	1,934
Outside services	1,248	2,060
Warranty, current portion	2,074	1,243
Accrued interest	2,487	3,866
Foreign exchange settlement	3,231	
Other	5,147	5,304
Total accrued expenses	$ 31,921	$ 24,431

Other non-current liabilities consisted of the following (in thousands):

	2008	2007
Contingent purchase consideration	$ 5,186	$ 4,286
Deferred rent	1,746	1,791
Warranty liability, net of current portion	5,020	2,802
Deferred revenue, net of current portion	1,367	2,073
Other	431	123
Total deferred liabilities	$ 13,750	$ 11,075

We have classified amounts of our warranty liability as non-current based upon our estimated timing of repair costs. The warranty liability is summarized as follows (in thousands):

	Beginning of year	Charged to cost of revenue	Applied to liability	End of year
Year ended December 31, 2008	$ 4,045	$ 4,773	$ (1,724)	$ 7,094
Year ended December 31, 2007	$ 2,318	$ 3,160	$ (1,433)	$ 4,045
Year ended December 31, 2006	$ 995	$ 2,397	$ (1,074)	$ 2,318

7. Acquisitions

In July 2007, we acquired all of the outstanding stock of LumenVu, Inc. (LumenVu), a private development stage company that developed, in conjunction with a leading academic research institution, a patented technology to improve the accuracy of catheter placement. We acquired technology that is a real-time bedside catheter tip visualization system that can be used to improve accuracy of catheter placements. This technology eliminates guesswork by the clinician in blind placements. It couples near infrared light with standard catheter technology, utilizing

an optical waveguide that is combined with a guidewire and aligned with the tip of a conventional catheter. A laser diode is used to send near infrared light down the waveguide, lighting up the tip. As the catheter is positioned, a specialized camera captures light from the tip of the guidewire and images are projected real-time onto a monitor positioned by the patient s bedside. The technology was exclusively licensed to LumenVu by a leading academic research institution. During 2010, we intend to integrate this technology in a new product line that can be sold along with existing product lines in certain clinical markets.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Acquisitions (Continued)

The results of LumenVu s operations were included in our consolidated financial statements since the date of the acquisition. The acquisition, which was an asset purchase, had a purchase price that consisted of cash consideration of $2.9 million, note receivable forgiveness of $0.1 million, assumed liabilities of $0.6 million, which were paid at closing, and contingent future cash payments of $10.0 million, which had an estimated fair value of $4.0 million at the date of acquisition. The future cash payments are contingent upon the continued development of the product and revenues recognized from the sale of products incorporating this technology. The liability for contingent consideration is accreted to operating expenses over the expected payment period. During 2008 and 2007, we recorded $0.9 million and $0.3 million, respectively, of accretion expense. Based on the fair value of assets acquired $11.8 million was allocated to an intangible technology asset, which will be amortized over ten years commencing with sales of products incorporating this technology. No amortization expense has been recorded in 2008 or 2007. Since the amortization of this intangible technology asset is not deductible for tax purposes we have recorded a deferred tax liability of $4.3 million. Additionally, we recorded a deferred tax asset associated with net operating losses of LumenVu of $0.2 million.

In May 2004, we acquired 100% of the outstanding common shares of SonoMetric Health, Inc. (SonoMetric). The results of SonoMetric s operations have been included in our consolidated financial statements since that date. We purchased all of SonoMetric s outstanding common shares for an immediate cash payment of $1.5 million, plus future cash payments of up to $4.5 million contingent upon the amount of revenue recognized from the sale of the purchased software over the five-year period following the closing date of the acquisition. We accrued contingent payments of $0.4 million and $1.0 million as of December 31, 2008 and 2007, respectively, as a result of revenue recognized on the sale of the software. These contingent payments, which expire in April 2009, are recorded as additional goodwill.

8. Goodwill and other intangible assets

As of December 31, 2008 and 2007, goodwill was $3.8 million and $3.4 million, respectively. As of December 31, 2008 intangible assets subject to amortization, which collectively had a remaining weighted average useful life of 10.8 years, were $12.5 million, net of accumulated amortization of $1.6 million. As of December 31, 2007 intangible assets subject to amortization were $12.4 million, net of accumulated amortization of $1.4 million. Amortization expense of $0.2 million, $0.3 million and $0.4 million related to intangible assets was recorded for the years ended December 31, 2008, 2007 and 2006. Amortization expense of intangible assets is estimated to be $0.2 million in 2009, $1.4 million in 2010, $1.3 million in 2011, and $1.2 million in 2012. As of December 31, 2008 and 2007, indefinite-lived intangible assets were $0.5 million. During the fourth quarter of 2008, we completed our annual impairment assessment of our goodwill and indefinite-lived intangible assets and determined that they were not impaired.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Hedging activities

During 2008 the currencies hedged were the British pound, the European Union euro, the Japanese yen, the Australian dollar and the Canadian dollar. As of December 31, 2008, we had $55.6 million in notional amount of foreign currency forward and participating forward contracts. The fair value of these contracts as of December 31, 2008 was not material to our results of operations or financial position. These contracts expire on January 31, 2009 and serve as economic hedges of a substantial portion of our intercompany balances denominated in a currency other than the USD. The recognized gains and losses, which are included in other income on the consolidated statement of income, of foreign currency hedge contracts and the intercompany receivables are as follows (in thousands):

	2008	2007	2006
Foreign currency hedges	$ 217	$ (2,119)	$ (1,103)
Intercompany receivables	(2,649)	3,565	1,470
Net (loss) gain from foreign currency	$ (2,432)	$ 1,446	$ 367

10. Convertible senior notes

In July 2007, we completed the offering of $225.0 million aggregate principal amount of 3.75% convertible senior notes (Notes) due 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.

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.

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. Debt issuance costs of approximately $7.1 million are being amortized to interest expense over the term of the Notes, which have no restrictive covenants, and have been included in other assets in our consolidated balance sheet.

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.

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 $15.7 million in other income. The payment received from

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Convertible senior notes (Continued)

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 $2.2 million of debt issuance costs. Following the repurchases, debt issuance costs approximated $3.9 million.

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 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.

Upon issuance of the Notes, 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.

First we concluded that the economic characteristics and risks of the embedded derivative are not clearly and closely related to the host contract. Also, we determined the host contract would not be remeasured at fair value with changes reported in earnings. Further, we concluded that the conversion option would meet the characteristics of a derivative instrument if it were a separate instrument.

Since the conversion option spread is solely indexed to our stock; will be paid entirely in our stock; and is not considered a conventional instrument due to the existence of a make whole premium, we evaluated whether the conversion feature should be bifurcated. All the conditions for equity classification were met. We therefore concluded the conversion feature should be equity classified and not recorded as a standalone derivative, and thus the conversion feature was exempt from bifurcation.

As a result, we recorded the Notes and conversion option as a single instrument with no debt discount.

We evaluated our call options and warrants using the Technical Practice Aid. In doing so we considered whether the call options and warrant were mandatorily redeemable or had an obligation to repurchase. Also, we gave consideration to whether these transactions were part of an integrated transaction.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Convertible senior notes (Continued)

We do not consider the call options and warrant transactions to be integrated with our senior convertible notes. Neither the call options nor warrant transaction were required with issuance of our notes. These were separate transactions entered into with counterparties different than the note holders. Additionally, the call options and warrant transaction were effective for the Notes issued in the initial issuance but not the over-allotment issuance.

We concluded the instruments are not in the form of shares that are mandatorily redeemable nor do the instruments embody an obligation for the Company to repurchase its own equity shares by transferring assets.

Additionally, the purchased call and the warrant are not financial instruments that shall be classified as a liability as the monetary value of any obligation related to the instruments is not based solely or predominantly on any of the following:

1. A fixed monetary amount known at inception: the warrant settlement is not based on a fixed monetary amount.

2. Variations in something other than the fair value of the issuer s shares: the ultimate settlement amount is determined directly based on the fair value of the Company s shares when exercised.

3. Variations inversely related to the changes in the fair value of the issuer s equity shares: this is not applicable, as the settlement value is directly, not inversely, related to the fair value of the shares.

Since we concluded that neither instrument required liability or asset classification, the evaluation of these instruments was made whether they qualify for equity classification.

The call option, only net-share settleable, is therefore classified as equity. The warrant, also only net-share settleable, is therefore equity classified.

11. Shareholders equity

Stock compensation plans

At December 31, 2008, we had six stock-based employee compensation plans: the 1998 Nonofficer Employee Stock Option Plan (1998 NOE Plan), the 1998 Stock Option Plan (1998 Plan), the Nonemployee Director Stock Option Plan (Director Plan), the Management Incentive Compensation Plan (MIC Plan), the Amended and Restated 2005 Stock Incentive Plan (2005 Plan), and the 2005 Employee Stock Purchase Plan (2005 ESPP Plan).

Total stock-based compensation expense recognized in our consolidated statements of operations for the years ended December 31, 2008, 2007 and 2006 consisted of the following (in thousands):

	2008	2007	2006
Stock options	$ 1,978	$ 2,968	$ 4,027
Restricted stock units	6,105	3,298	2,709
Employee stock purchase plan	626	543	592

Total stock-based compensation	$ 8,709	$ 6,809	$ 7,328

The related deferred tax benefit was $3.0 million, $2.3 million and $2.2 million for the years ended December 31, 2008, 2007 and 2006. The amount of stock-based compensation capitalized to inventory was not material as of December 31, 2008 or 2007.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. Shareholders equity (Continued)

Under the 1998 NOE Plan, 1998 Plan, MIC Plan, 2005 Plan, and option grants outside our stock option plans, as of December 31, 2008, 7,240,000 total shares of common stock were authorized primarily for issuance upon exercise of stock options at prices equal to the fair market value of our common shares at the date of grant. As of December 31, 2008, 2,387,927 of those shares granted under the plans were still outstanding, and 1,004,792 shares were still available for grant under these stock option plans. In most cases, stock options vest 25% after one year of employment and then monthly over the next three years, and grants made to employees after their first year of employment vest monthly over four years. Certain stock options vest 25% each year over a four year vesting period. All options have either a seven or ten year term from the grant date.

Under the Director Plan, as of December 31, 2004, 125,000 shares of common stock were authorized for issuance of stock options at prices equal to the fair market value of our common shares at the date of grant. At December 31, 2005, there were no longer shares available for grant under this Plan. Stock options are exercisable and vest in full one year following their grant date provided the optionee has continued to serve as our director. Each option expires on the earlier of ten years from the grant date or 90 days following the termination of a director s service as our director.

The 2005 ESPP Plan, which qualifies under Section 423 of the Internal Revenue Code, permits all U.S. based employees to purchase shares of our common stock. Participating employees may purchase common stock through payroll deductions at the end of each participation period at a purchase price equal to 85% of the lower of the fair market value of the common stock at the beginning or the end of the participation period. As of December 31, 2008 1,000,000 shares of common stock were authorized for issuance under the 2005 ESPP Plan. During the years ended December 31, 2008, 2007 and 2006, 95,248, 74,501 and 76,907 shares of common stock were issued under this plan, respectively.

Prior to the spin-off from ATL, we had no stock option plans specifically identified as our plans. All stock options granted through that date were part of ATL option plans.

Through 2004, we granted a total of 165,000 options outside of all plans to corporate officers, of which 85,000 options are outstanding. These options are included within the information presented herein and contain similar provisions to our 1998 Plan.

The fair value for stock option awards was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions for the years ended December 31, 2008, 2007 and 2006:

	Stock Options			ESPP		
	2008	2007	2006	2008	2007	2006
Expected term (in years)	5.0	5.0	4.6	0.5	0.5	0.5
Expected stock price volatility	34%	38%	41%	41%	28%	29%
Risk-free interest rate	2.7%	4.7%	4.6%	1.5%	4.5%	5.0%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Weighted average fair value of options granted	$ 7.55	$ 12.13	$ 16.45	$ 6.92	$ 7.70	$ 7.92

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. Expected stock price volatility is based on historical volatility of our

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. Shareholders equity (Continued)

stock over the historical period commensurate with the expected term assumptions. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant with an equivalent remaining term. We have not paid dividends in the past and do not plan to pay any dividends in the near future.

Summary of stock option activity

The following table presents summary stock option activity for the year ended December 31, 2008 (shares presented in thousands):

	Shares	Weighted average exercise price	Weighted average remaining contractual life	Aggregate intrinsic value (in thousands)
Outstanding, beginning of year	1,461	$ 25.79		
Granted	603	$ 21.60		
Exercised	(165)	$ 15.22		
Forfeited	(167)	$ 32.13		
Expired	(19)	$ 40.52		
Outstanding, end of year	1,713	$ 24.54	4.80	$ 2,076
Exercisable, end of year	1,236	$ 26.63	4.03	$ 1,179

The aggregate intrinsic value in the table above is based on our stock price of $18.67 on December 31, 2008, which would have been received by the optionees, without reduction for applicable income taxes, had all options been exercised on that date. As of December 31, 2008, total unrecognized stock-based compensation expense related to nonvested stock options was $2.6 million, which is expected to be recognized over a weighted average period of approximately 3.5 years. During the years ended December 31, 2008, 2007 and 2006, the total intrinsic value of stock options exercised was $3.0 million, $3.6 million and $11.1 million, respectively.

We issue new shares of common stock upon exercise of stock options.

The following is a summary of stock options outstanding as of December 31, 2008 (shares presented in thousands):

	Options outstanding			Options exercisable	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
$10.70 $16.43	300	3.28	$ 14.85	300	$ 14.85
$16.44 $16.49	403	6.89	$ 16.44	0	$ 0.00
$16.50 $28.24	347	4.56	$ 22.28	337	$ 22.10

$28.25	$38.96	421	4.44	$ 31.90	376	$ 31.88
$38.97	$40.58	242	4.16	$ 40.48	223	$ 40.47
		1,713	4.80	$ 24.54	1,236	$ 26.63

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. Shareholders equity (Continued)

Restricted stock units

We have granted restricted stock unit (RSU) awards to employees under the 1998 Plan and 2005 Plan. Generally, the vesting period for our RSU awards is three years from the date of grant. As of December 31, 2008, total unrecognized stock-based compensation expense related to nonvested RSU awards was $6.3 million, which is expected to be recognized over a weighted average period of approximately 1.4 years.

The following table presents summary RSU award activity for the year ended December 31, 2008 (shares presented in thousands):

	Shares	Weighted average grant date fair value
Non-vested, beginning of period	493	$ 35.06
Granted	295	$ 23.91
Forfeited	(51)	$ 31.46
Vested	(62)	$ 35.14
Non-vested, end of period	675	$ 30.50

Stock purchase rights

In April 1998, we and First Chicago Trust Company of New York (First Chicago) entered into a Rights Agreement. The Rights Agreement was subsequently amended in October 2001 to reflect that EquiServe Trust Company, N.A. had succeeded First Chicago as the rights agent, and in August 2003, and again in November 2007, to reflect that Computershare Trust Company N.A. had succeeded EquiServe and to adopt certain changes approved by our Board of Directors. The Rights Agreement has certain anti-takeover provisions, which will cause substantial dilution to a person or group that attempts to acquire us. Under the Rights Agreement, each of our shareholders has one share purchase right for each share of common stock held, with each right having an exercise price approximating our board of directors estimate of the long-term value of one share of our common stock. The rights are triggered if an acquiror acquires, or successfully makes a tender offer for, 20% or more of our outstanding common stock. In such event, each shareholder other than the acquiror would have the right to purchase, at the exercise price, a number of newly issued shares of our capital stock at a 50% discount. If the acquiror were to acquire 50% or more of our assets or earning power, each shareholder would have the right to purchase, at the exercise price, a number of shares of acquiror s stock at a 50% discount. Our board of directors may redeem the rights at a nominal cost at any time before a person acquires 20% or more of our outstanding common stock, which allows board-approved transactions to proceed. In addition, our board of directors may exchange all or part of the rights (other than rights held by the acquiror) for such number of shares of our common stock equal in value to the exercise price. Such an exchange produces the desired dilution without actually requiring our shareholders to purchase shares. The Rights Agreement expires on April 5, 2013.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. Income taxes

The components of income before income taxes are as follows (in thousands):

	2008	2007	2006
U.S. operations	$ 32,608	$ 7,968	$ 5,334
Foreign operations	1,475	3,048	2,479
Total income before income taxes	$ 34,083	$ 11,016	$ 7,813

The components of income tax provision (benefit) are as follows (in thousands):

	2008	2007	2006
Current:			
U.S. Federal	$ 1,985	$ 536	$ 170
State and local	1,175	466	77
Foreign	1,408	1,197	115
Total Current	4,568	2,199	362
Deferred:			
U.S. Federal	9,436	1,419	1,931
State and local	(108)	20	141
Foreign	(399)	494	(1,852)
Total Deferred	8,929	1,933	220
Total income tax provision	$ 13,497	$ 4,132	$ 582

The provision for income taxes differs from the amount computed by applying the federal statutory income tax rate to the net income or loss. The sources and tax effects of the differences for the years ended December 31 are as follows:

	2008	2007	2006
U.S. federal tax expense at statutory rates	35.0%	35.0%	34.0%
State income taxes, net of federal benefit	2.0%	1.6%	1.9%
Meals and entertainment and other non-deductible expenses	0.4%	1.3%	1.6%
Expiring state net operating losses			1.3%
Research and experimentation credits	(1.2)%	(3.3)%	(2.5)%
Foreign tax rates	0.4%	1.8%	1.2%
Deferred tax rate change	0.1%	(2.9)%	(0.2)%
Other	2.9%	4.0%	1.7%
Valuation allowance changes and tax uncertainties			(31.6)%

Effective tax rate	39.6%	37.5%	7.4%

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. Income taxes (Continued)

Deferred tax assets and deferred tax liabilities are comprised of the following at December 31 (in thousands):

	2008	2007
Deferred tax assets:		
Domestic net operating loss carryforwards	$	$ 10,666
Foreign net operating loss carryforwards	634	608
Research and experimentation tax credit carryforwards	2,280	2,866
Allowances and accruals not recognized for tax purposes	9,649	5,488
Stock-based compensation	6,108	4,661
Depreciation	576	331
Other	939	1,477
Gross deferred tax assets	20,186	26,097
Deferred tax liabilities:		
Intangibles and amortization	(4,697)	(4,643)
Net deferred tax assets	$ 15,489	$ 21,454

The valuation allowance was zero as of December 31, 2008 and 2007. The valuation allowance on foreign deferred tax assets was eliminated in 2006 because consideration of all relevant factors, including current operations and recent earnings history indicate that realization of the related deferred tax assets are now more likely than not to occur.

For income tax purposes, our results through the spin-off from ATL were included in the consolidated federal income tax return of ATL and, accordingly, the net operating loss (NOL) generated prior to the spin-off from ATL is not available to us for use in periods subsequent to that date. As of December 31, 2008 we have fully utilized the the US federal income tax NOL carryforwards. We have net foreign NOL carryforwards of $0.6 million, which are perpetual in nature. Additionally, we have research and experimentation tax credit carryforwards of $2.3 million that expire between 2018 and 2027.

We have not provided for U.S. deferred taxes on earnings of non-U.S. subsidiaries as such earnings, which are immaterial, are deemed permanently reinvested. Determination of unrecorded deferred taxes on earnings of non-U.S. subsidiaries is not practicable.

Under certain provisions of the Internal Revenue Code of 1986, as amended, the availability and utilization of our NOL and tax credit carryforwards may be subject to limitation if it should be determined that there has been a change in ownership of more than 50%.

Our unrecognized tax benefits at December 31, 2008 and 2007 relate to various foreign jurisdictions and U.S. tax credits. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

	2008	2007
Beginning of year	$ 3.418	$ 3,225
Increases related to current year tax positions	92	92
(Decreases) increases related to foreign currency translation	(319)	158

Decreases related to change in foreign tax rate		(57)
End of year	$ 3,191	$ 3,418

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. Income taxes (Continued)

The entire $3.2 million of unrecognized tax benefits at December 31, 2008 would reduce income tax expense if ultimately recognized. We do not expect any significant increases or decreases to our unrecognized tax benefits within 12 months of this reporting date.

Interest and penalties incurred associated with unresolved income tax positions are included in income tax expense. Accrued interest and penalties are insignificant.

In the normal course of business, we are subject to examination by tax authorities throughout the world, including such major jurisdictions as the U.S., France, Japan, and United Kingdom. We are subject to U.S. federal, state and local, or non-U.S. income tax examinations for years after 2001. However, carryforward attributes that were generated prior to 2003 may still be adjusted by a taxing authority upon examination if the attributes have been or will be used in a future period.

13. Employee Benefit Plan

401(k) Retirement Savings Plan

All our employees in the U.S. are eligible to participate in our 401(k) Plan. Terms of the 401(k) Plan permit an employee to contribute up to a maximum of 16% of an employee s annual compensation on a post-tax or pre-tax basis, up to the maximum permissible by the Internal Revenue Service during any plan year. At our discretion, we match each employee s contribution in increments equivalent to 100% for the first 3% and 50% for the second 3% of the employee s contribution percentage. In 2008, 2007 and 2006 we contributed $1.5 million, $1.2 million and $1.3 million in matching contributions to the 401(k) Plan in accordance with the plan s terms. Employees immediately vest in the contributions the employee makes. Vesting in our contribution on behalf of the employee occurs at equal increments at the end of each year of the first five years of an employee s service with us.

14. Commitments and contingencies

Indemnification Obligations and Guarantees (excluding product warranty)

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

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. Commitments and contingencies (Continued)

Operating leases

We currently lease office and manufacturing space, automobiles and office equipment under operating leases. Future minimum lease payments are as follows (in thousands):

2009	$ 3,527
2010	3,065
2011	2,611
2012	2,303
2013	2,136
Thereafter	700
Total	$ 14,342

Rent expense for the years ended December 31, 2008, 2007 and 2006 was $3.2 million, $3.2 million and $2.8 million.

Other commitments

In 2008, we entered into an agreement to contribute up to 12 systems to a research university. This pledge, which is to be donated over a four-year period, will commence in 2010.

In 2005, we entered into an agreement to contribute up to $1.0 million to a research university. This pledge, which is to be paid over a four-year period, is conditioned upon our election to make a payment on an annual basis. We have committed to contribute $0.1 million in 2009. In relation to these contributions, we expensed $0.3 million in 2008, $0.3 million in 2007, and $0.3 million in 2006.

As part of our agreements with our suppliers, suppliers may procure resources and material expected to be used for the manufacture of our product in accordance with our production schedule provided to them. In the event these items are not used in the quantities submitted as part of the production schedule or material becomes obsolete as a result of production timing, material changes or design changes, we may be responsible for compensating our suppliers for these procurements. As of December 31, 2008, these commitments were not significant.

At December 31, 2008 we maintained a deposit of $0.7 million with our bank in the United Kingdom as security for payment of customs and duties charges. At December 31, 2007 this amount was $1.0 million. These amounts are included in other long-term assets.

In the U.S., we have complemented our direct sales efforts by entering into group purchasing agreements with major healthcare group purchasing organizations (GPO). Typically, a GPO negotiates with medical suppliers, such as us, on behalf of the GPO s member healthcare facilities, providing such members with uniform pricing and terms and conditions. In exchange, the GPO identifies us as a preferred supplier for its members. Member facilities participating in the GPO s purchasing program can consist of hospitals, medical group practices, nursing homes, surgery centers, managed care organizations, long term care facilities, clinics and integrated delivery networks. These agreements require us to pay fees based on the amount of sales generated from these agreements. For the years ended December 31, 2008, 2007 and 2006, we recorded fees related to these agreements as sales and marketing expenses in the amounts of $2.1 million, $1.8 million and $1.4 million, respectively.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. Commitments and contingencies (Continued)

Contingencies

On February 21, 2007, we filed a patent infringement suit against Zonare Medical Systems, Inc. (Zonare) in the federal district court of the Central District of California alleging that Zonare infringed our U.S. patent 5,722,412 through sales of its z.one ultrasound system. On March 14, 2007, Zonare filed an answer to our claim which included a counterclaim against us alleging that our products infringe its U.S. patent 6,980,419 related to its portable docking station. On July 16, 2008, we settled all claims and counterclaims in this suit with Zonare. The parties entered a settlement agreement that included among other terms, a cross license of the patents-in-suit limited to certain existing products of each party, and mutual releases and covenants not to sue for a certain period of time. Net income in both the third quarter and nine month period of 2008 included a $1.5 million after-tax benefit for the settlement of the Zonare patent lawsuit.

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, the parties filed a stipulation for dismissal without prejudice for the remaining claims and counterclaims for the three remaining patents that have yet to be ruled on by summary judgment in this case, thereby negating the need for a trial. On July 31, 2008, the court granted the parties request for dismissal of the remaining claims and counterclaims that had not been ruled on by the judge. The parties have appealed certain of the trial court s summary judgment decisions and other rulings to the Court of Appeals for the Federal Circuit. We do not expect an appellate decision until the second half of 2009. It is possible that the Federal Circuit may vacate certain of the trial court s rulings and remand them to the trial court for final resolution.

On May 22, 2008, GE filed a second suit in the same federal court in Wisconsin seeking to invalidate our U.S. patent 5,722,412. We are defending this lawsuit and expect to go to trial in June 2009.

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

15. Related party transaction

In January 2007, we accepted 4,560 shares of common stock valued at approximately $133,000 along with cash from our President and Chief Executive Officer as payment of the exercise price for 19,218 options, pursuant to the terms of the 1998 plan. The shares were valued at the closing stock price on the date of the transaction.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

16. Segment reporting

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 on a disaggregated basis. Geographic regions are determined by the shipping destination. Revenue by geographic location for the years ended December 31 is as follows (in thousands):

	2008	2007	2006
United States	$ 116,677	$ 104,147	$ 89,732
Europe, Africa and the Middle East	72,202	58,955	48,940
Latin America and Canada	24,517	17,770	12,260
Asia Pacific	30,128	24,196	20,151
Total revenue	$ 243,524	$ 205,068	$ 171,083

Long-lived assets, excluding investment securities and deferred tax assets, included in other assets, by geographic location as of December 31 are as follows (in thousands):

	2008	2007
United States	$ 13,203	$ 16,848
International	2,217	2,806
Total long-lived assets	$ 15,420	$ 19,654

17. Subsequent Events

In 2009, we repurchased $25.0 million in principal amount of our senior convertible notes for $20.5 million. Following these repurchases, $119.7 million of principal in convertible notes is outstanding. We expect to record a gain, net of related deferred financing costs and costs to complete the repurchase transactions, in the first quarter of 2009. In connection with the recent repurchase of our senior convertible notes, the associated convertible note hedges and a corresponding number of warrant positions will be unwound. The payment received from unwinding the associated convertible note hedges, less the cost of the warrant transaction, will result in net proceeds to us of approximately $0.1 million.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

18. Quarterly results unaudited

	For the three months ended,			
	March 31	June 30	September 30	December 31
	(in thousands, except per share amounts)			
2008:				
Revenue	$ 52,499	$ 59,230	$ 61,633	$ 70,162
Cost of revenue	14,659	17,741	18,562	22,753
Gross margin	37,840	41,489	43,071	47,409
Operating expenses	35,446	36,146	33,051	42,734
Other income (loss)	(151)	(956)	(1,701)	14,460
Income tax provision	(998)	(1,863)	(3,593)	(7,044)
Net income	$ 1,245	$ 2,524	$ 4,726	$ 12,091
Net income per share:				
Basic	$ 0.07	$ 0.15	$ 0.28	$ 0.71
Diluted	$ 0.07	$ 0.14	$ 0.27	$ 0.69
Shares used in computation of net income per share:				
Basic	16,770	16,843	16,927	17,028
Diluted	17,406	17,456	17,592	17,511
2007:				
Revenue	$ 42,795	$ 47,397	$ 50,041	$ 64,835
Cost of revenue	12,875	14,651	15,292	19,687
Gross margin	29,920	32,746	34,749	45,148
Operating expenses	32,168	31,276	35,089	39,579
Other income (loss)	1,302	1,272	2,469	1,522
Income tax (provision) benefit	383	(1,035)	(642)	(2,838)
Net income (loss)	$ (563)	$ 1,707	$ 1,487	$ 4,253
Net income (loss) per share:				
Basic	$ (0.03)	$ 0.10	$ 0.09	$ 0.25
Diluted	$ (0.03)	$ 0.10	$ 0.09	$ 0.25
Shares used in computation of net income (loss) per share:				
Basic	16,494	16,606	16,657	16,723
Diluted	16,494	17,112	17,188	17,350

During the fourth quarter of 2008, we recorded a $3.0 million pre-tax charge associated with terminated acquisition talks and severance charges. We also recorded a pre-tax gain of $15.7 million in relation to the repurchase of our senior convertible notes.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE
None.

ITEM 9A. CONTROLS AND PROCEDURES
(a) Evaluation of disclosure controls and procedures

As of December 31, 2008, 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.

(b) Management s report on internal control over financial reporting

Our management is responsible for establishing and maintaining adequate internal controls over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2008 as required by the Exchange Act Rule 13a-15(c). Our management s evaluation of our internal control over financial reporting concluded that, as of December 31, 2008, our internal controls over financial reporting were effective. In making this assessment, our management used the criteria issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control Integrated Framework*.

KPMG LLP, an independent registered public accounting firm, has issued an audit report on the effectiveness of our internal control over financial reporting. Their report is included in Item 8. in the section titled Reports of Independent Registered Public Accounting Firm.

(c) Changes in internal control over financial reporting

During 2008, we continued to make improvements to our system of internal control and to review, revise, and improve the effectiveness of our internal controls. We have made no changes, other than the items noted below, in the Company s internal controls over financial reporting in connection with our fourth quarter evaluation that would materially affect, or are reasonably likely to materially affect, our internal control over financial reporting.

During the fourth quarter of 2008, our tax resource, who had the background and expertise in the tax provision preparation process, resigned. We continue to use external resources to provide additional expertise related to accounting and reporting for income taxes.

ITEM 9B. OTHER INFORMATION
For each of the executive officers named in the 2008 proxy statement under the heading Executive Officers, we have entered into change-in-control agreements. These agreements are substantially similar to each other. We will file the proxy statement within 120 days of December 31, 2008.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is included in our proxy statement for our 2009 annual meeting of shareholders and is incorporated by reference. The information appears in the proxy statement under the headings Election of Directors and Executive Officers. We will file the proxy statement within 120 days of December 31, 2008.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is included in our proxy statement for our 2009 annual meeting of shareholders and is incorporated by reference. The information appears in the proxy statement under the heading Executive Compensation. We will file the proxy statement within 120 days of December 31, 2008.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Security Ownership of Certain Beneficial Owners and Management

The information required by this Item is included in our proxy statement for our 2009 annual meeting of shareholders and is incorporated by reference. The information appears in the proxy statement under the heading Security Ownership of Certain Beneficial Owners and Management. We will file the proxy statement within 120 days of December 31, 2008.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table provides information regarding our existing compensation plans and individual compensation arrangements pursuant to which our equity securities may be issued to employees, directors, consultants, advisors or other persons in exchange for consideration in the form of services as of December 31, 2008.

Plan Category	Number of securities to be issued upon exercise of outstanding options, restricted stock units, warrants and rights (a)	Weighted-average exercise price of outstanding options, restricted stock units, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	2,068,000(1)	$ 16.80	1,005,000
Equity compensation plans not approved by security holders	320,000(2)	$ 22.84	
Total	2,388,000	$ 17.61	1,005,000

(1) Issuable under our 1998 Stock Option Plan, Management Incentive Compensation Plan, Nonemployee Director Stock Option Adjustment Plan and 2005 Stock Incentive Plan. The plans are described in Note 10 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

(2)

Issuable under our 1998 Nonofficer Employee Stock Option Plan as described in Note 10 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008. Also includes 85,000 options outside of all plans issued to corporate officers, which are also described in Note 9 to the Consolidated Financial Statements.

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ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by this Item is included in our proxy statement for our 2009 annual meeting of shareholders and is incorporated by reference. The information appears in the proxy statement under the heading Certain Relationships and Related Transactions. We will file the proxy statement within 120 days of December 31, 2008.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item is included in our proxy statement for our 2009 annual meeting of shareholders and is incorporated by reference. The information appears in the proxy statement under the heading Fee Disclosures. We will file the proxy statement within 120 days of December 31, 2008.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES
(a) Documents filed as part of this report:

(1) Financial Statements See Index to Financial Statements under Item 8 of this Report.

(2) Financial Statement Schedule Schedule II Valuation and Qualifying Accounts

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Schedule II

Valuation and Qualifying Accounts

	Beginning of year	Expenses and adjustments	Write-offs	End of year
		(in thousands)		
Accounts Receivable Allowances				
Year ended December 31, 2008	$ 957	$ 1,492	$ 259	$ 2,190
Year ended December 31, 2007	$ 1,145	$ 1,536	$ 1,724	$ 957
Year ended December 31, 2006	$ 1,227	$ 1,500	$ 1,582	$ 1,145

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(3) Exhibits.

Exhibit No.	Description
1.1(K)	Underwriting Agreement between J.P. Morgan Securities Inc. and the registrant dated July 10, 2007 (exhibit 1.1)
3.1(A)	Restated Articles of Incorporation of the registrant (exhibit 3.1)
3.2(D)	Amended and Restated Bylaws of the registrant (exhibit 3.1)
4.1(K)	First Supplemental Indenture between Wells Fargo Bank, NA and the registrant dated July 16, 2007 (exhibit 4.1)
4.2(M)	Amended and Restated Rights Agreement dated November 28, 2007 by and between the registrant and Computershare Trust Company N.A. (exhibit 4.1)
4.3(M)	Form of Rights Certificate (exhibit 4.2)
10.1(F)	1998 Stock Option Plan, as amended and restated (exhibit 10.1)
10.2(A)	Terms of Stock Option Grant Program for Nonemployee Directors under the SonoSite, Inc. 1998 Stock Option Plan (exhibit 10.2)
10.3(G)	1998 Nonofficer Employee Stock Option Plan, as amended and restated (exhibit 10.1)
10.4(D)	Nonemployee Director Stock Option Plan, as amended and restated (exhibit 10.3)
10.5(B)	Management Incentive Compensation Plan (exhibit 10.5)
10.6(A)	Technology Transfer and License Agreement between ATL Ultrasound, Inc. and the registrant, effective as of April 6, 1998, as amended (exhibit 10.9)
10.7(E)	Third Amendment to Technology Transfer and License Agreement between ATL Ultrasound, Inc. and the registrant, dated as of March 10, 2000 (exhibit 10.9)
10.8(C)	Option Notice Agreement, dated July 17, 2000, between the registrant and Michael J. Schuh (exhibit 99.1)
10.9(H)	2005 Employee Stock Purchase Plan (exhibit 10.2)
10.10(I)	1998 Stock Option Plan Stock Option Award Agreement (exhibit 10.1)
10.11(J)	Terms of Stock Option Grant Program for Nonemployee Directors under the SonoSite, Inc. 2005 Stock Incentive Plan (exhibit 10.1)
10.12(J)	2005 Stock Incentive Plan Stock Option Agreement (Non Statutory) (exhibit 10.2)
10.13(J)	2005 Stock Incentive Plan Restricted Stock Unit Agreement (Non Statutory) (exhibit 10.3)
10.14(L)	Call Option Transaction Confirmation, dated as of July 11, 2007, by and between SonoSite, Inc. and JPMorgan Chase Bank, National Association (exhibit 10.1)
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10.17(M)	Form of Partial Unwind Agreement with respect to the Warrant Confirmation dated July 11, 2007, by and between SonoSite, Inc. and JPMorgan Chase Bank, NA (exhibit 10.2)
10.18(N)	Amended and Restated 2005 Stock Incentive Plan (exhibit 99.1)
10.19(O)	FY2009 Variable Incentive Bonus Plan (exhibit 10.1)

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Exhibit No.	Description
10.20	Form of Senior Management Employment Agreement by and between SonoSite, Inc. and each of its Named Executive Officers.
21.1	Subsidiaries of the registrant
23.1	Consent of KPMG LLP, independent registered public accounting firm
24.1	Power of attorney (contained on signature page)
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)

Filed herewith.

* Confidential treatment requested.

(A) Incorporated by reference to the designated exhibit included in SonoSite s Registration Statement on Form S-1 (Registration No. 333-714157) filed on October 3, 1999.

(B) Incorporated by reference to the designated exhibit included in SonoSite s report on Form 10-K for the year ended December 31, filed on March 22, 1999.

(C) Incorporated by reference to the designated exhibit included in SonoSite s registration statement on Form S-8 (Registration No. 333-51820) filed on December 14, 2000.

(D) Incorporated by reference to the designated exhibit included in SonoSite s report on Form 10-Q for the quarter ended September 30, 2001 filed on November 13, 2001.

(E) Incorporated by reference to the designated exhibit included in SonoSite s report on Form 10-K for the year ended December 31, 2001 filed on February 22, 2002.

(F) Incorporated by reference to the designated exhibit included in SonoSite s report on Form 10-Q for the quarter ended March 31, 2002 filed on May 13, 2002.

(G) Incorporated by reference to the designated exhibit included in SonoSite s report on Form 10-Q for the quarter ended June 30, 2002 filed on August 13, 2002.

(H) Incorporated by reference to the designated exhibit included in SonoSite s report on Form 8-K filed on April 28, 2005.

(I) Incorporated by reference to the designated exhibit included in SonoSite s report on Form 10-Q for the quarter ended June 30, 2005 filed on August 9, 2005.

(J) Incorporated by reference to the designated exhibit included in SonoSite s report on Form 8-K filed on February 7, 2006.

(K) Incorporated by reference to the designated exhibit included in SonoSite s report on Form 8-K filed on February 16, 2007.

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(O) Incorporated by reference to the designated exhibit included in SonoSite s report on Form 8-K filed on November 3, 2008.

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SIGNATURES

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.

By /s/ MICHAEL J. SCHUH
Michael J. Schuh

Vice President and Chief Financial Officer

Date: March 10, 2009

POWER OF ATTORNEY

Each person whose individual signature appears below hereby authorizes and appoints Kevin M. Goodwin and Michael J. Schuh, and each of them, with full power of substitution and resubstitution and full power to act without the other, as his true and lawful attorney-in-fact and agent to act in his name, place and stead and to execute in the name and on behalf of each person, individually and in each capacity stated below, and to file, any and all amendments to this report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing, ratifying and confirming all that said attorneys-in-fact and agents or any of them or their or his substitute or substitutes may lawfully do or cause to be done by virtue thereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Company and in the capacities indicated below on the 10th day of March 2009.

/s/ KIRBY L. CRAMER **Kirby L. Cramer**	Chairman of the Board
/s/ KEVIN M. GOODWIN **Kevin M. Goodwin**	President, Chief Executive Officer and Director (Principal Executive Officer)
/s/ MICHAEL J. SCHUH **Michael J. Schuh**	Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)
/s/ CARMEN L. DIERSEN **Carmen L. Diersen**	Director
/s/ EDWARD V. FRITZKY **Edward V. Fritzky**	Director
/s/ STEVEN R. GOLDSTEIN, M.D. **Steven R. Goldstein, M.D.**	Director
/s/ PAUL V. HAACK **Paul V. Haack**	Director

/s/ Robert G. Hauser, M.D.	Director
Robert G. Hauser, M.D.	
/s/ Richard O. Martin	Director
Richard O. Martin.	
/s/ William G. Parzybok, Jr.	Director
William G. Parzybok, Jr.	
/s/ Jacques Souquet, Ph.D.	Director
Jacques Souquet, Ph.D.	

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