SONOSITE INC
Form 10-Q
August 09, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended June 30, 2010

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 number 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 SE, Bothell, WA	**98021-3904**
(Address of Principal Executive Offices)	**(Zip Code)**

(425) 951-1200

(Registrant s Telephone Number, Including Area Code)

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

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

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

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨	Smaller reporting company ¨

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common Stock, $0.01 par value	**13,864,028**
(Class)	**(Outstanding as of July 21, 2010)**

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SonoSite, Inc.

Quarterly Report on Form 10-Q

For the Three and Six Ended June 30, 2010

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

SonoSite, Inc.

Condensed Consolidated Balance Sheets

(unaudited)

(In thousands, except share data)	June 30, 2010	December 31, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 44,476	$ 183,065
Short-term investment securities	65,372	74,682
Accounts receivable, less allowances of $2,270 and $1,471	64,180	71,347
Inventories	35,380	32,216
Deferred tax taxes, current	7,482	7,350
Prepaid expenses and other current assets	9,538	12,034
Total current assets	226,428	380,694
Property and equipment, net	9,742	9,160
Investment	4,000	
Deferred tax asset, net	682	775
Goodwill	36,392	3,902
Intangible assets, net	55,153	24,018
Other assets	4,451	4,425
Total assets	$ 336,848	$ 422,974
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 13,153	$ 6,175
Accrued expenses	23,976	25,923
Deferred revenue, current portion	5,575	5,504
Total current liabilities	42,704	37,602
Long-term debt, net	95,081	92,905
Deferred tax liability, net	4,710	5,083
Deferred revenue	16,414	18,081
Other non-current liabilities	16,012	14,873
Total liabilities	174,921	168,544
Commitments and contingencies		
Shareholders equity:		
Preferred stock, $1.00 par value		
Authorized shares 6,000,000		
Issued and outstanding shares none		
Common stock, $.01 par value		
Authorized shares 50,000,000		

Issued and outstanding shares:		
As of June 30, 2010 14,282,162	177	
As of December 31, 2009 17,354,355		174
Additional paid-in-capital	292,487	287,363
Accumulated deficit	(129,840)	(32,753)
Accumulated other comprehensive loss	(897)	(354)
Total shareholders equity	161,927	254,430
Total liabilities and shareholders equity	$ 336,848	$ 422,974

See accompanying notes to condensed consolidated financial statements.

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SonoSite, Inc.

Condensed Consolidated Statements of Income

(unaudited)

(In thousands, except net income per share)	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Revenue	$ 61,549	$ 52,285	$ 117,526	$ 104,090
Cost of revenue	17,195	15,299	33,475	32,012
Gross margin	44,354	36,986	84,051	72,078
Operating expenses:				
Research and development	7,211	7,375	14,808	15,072
Sales, general and administrative	30,996	27,584	60,425	53,387
Licensing income and litigation settlement		(924)		(924)
Total operating expenses	38,207	34,035	75,233	67,535
Other income (loss)				
Interest income	203	588	383	1,537
Interest expense	(2,459)	(2,349)	(4,752)	(4,943)
Other	(182)	(508)	(330)	933
Total other loss, net	(2,438)	(2,269)	(4,699)	(2,473)
Income before income taxes	3,709	682	4,119	2,070
Income tax provision	1,834	257	861	782
Net income	$ 1,875	$ 425	$ 3,258	$ 1,288
Net income per share:				
Basic	$ 0.13	$ 0.02	$ 0.21	$ 0.08
Diluted	$ 0.12	$ 0.02	$ 0.20	$ 0.07
Weighted average common outstanding:				
Basic	14,601	17,219	15,438	17,150
Diluted	15,100	17,619	15,950	17,567

See accompanying notes to condensed consolidated financial statements.

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SonoSite, Inc.

Condensed Consolidated Statements of Cash Flows

(unaudited)

(In thousands)	Six Months Ended June 30, 2010	2009
Operating activities:		
Net income	$ 3,258	$ 1,288
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,344	2,109
Stock-based compensation	2,208	3,943
Deferred income tax provision	(1,739)	863
Amortization of debt discount and debt issuance costs	2,001	2,559
Gain on convertible note repurchase		(1,339)
Excess tax benefit from exercise of stock-based awards	(532)	
Non-cash gain on litigation settlement		(924)
Other adjustments	(1)	200
Changes in operating assets and liabilities:		
Accounts receivable	8,949	12,347
Inventories	1,754	(966)
Prepaid expenses and other assets	4,741	236
Accounts payable	5,336	333
Accrued expenses	(6,524)	(12,734)
Deferred revenue	(1,595)	(1,055)
Deferred liabilities	113	514
Net cash provided by operating activities	21,313	7,374
Investing activities:		
Purchases of investment securities	(79,921)	(67,786)
Proceeds from sales/maturities of investment securities	89,298	68,843
Purchases of property and equipment	(1,428)	(1,810)
Purchase of VisualSonic, Inc, net of cash acquired	(61,217)	
Investment in Carticept Medical Inc.	(4,000)	
Payment of LumenVu contingent consideration	(425)	
Earn-out consideration associated with SonoMetric acquisition		(387)
Net cash used in investing activities	(57,693)	(1,140)
Financing activities:		
Excess tax benefit from stock-based compensation	532	
Minimum tax withholdings on stock-based awards	(692)	(852)
Proceeds from exercise of stock-based awards	3,271	1,385
Repurchase of convertible senior note		(20,500)
Stock repurchases including transaction costs	(97,715)	
Repayment of VisualSonics Inc. long-term debt	(8,838)	1,409
Repurchase of warrants		(1,325)
Net cash used in by financing activities	(103,442)	(19,883)
Effect of exchange rate changes on cash and cash equivalents	1,233	(1,743)
Net change in cash and cash equivalents	(138,589)	(15,392)

Cash and cash equivalents at beginning of period	183,065	209,258
Cash and cash equivalents at end of period	$ 44,476	$ 193,866
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 1,502	$ 2,457
Cash paid for interest	$ 2,317	$ 2,812
Supplemental disclosure of non cash flow information:		
Stock repurchases not yet settled	$ 2,496	$

See accompanying notes to condensed consolidated financial statements.

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SonoSite, Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

Interim Financial Information

1. Summary of significant accounting policies

Basis of Presentation

The information contained herein has been prepared in accordance with instructions for Form 10-Q and Article 10 of Regulation S-X. The information reflects, in the opinion of SonoSite, Inc. management, all adjustments necessary (which are of a normal and recurring nature) for a fair presentation of the results for the interim periods presented. The results of operations for the three and six months ended June 30, 2010 are not necessarily indicative of expected results for the entire year ending December 31, 2010 or for any other fiscal period. These financial statements do not include all disclosures required by generally accepted accounting principles. For a presentation including all disclosures required by generally accepted accounting principles, these financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2009, included in our Annual Report on Form 10-K.

Revenue

Effective January 1, 2010, we adopted new revenue recognition accounting guidance, which removes tangible products from the scope of the software revenue guidance if the products contain both software and non software components that function together to deliver a product s essential functionality. It also provides guidance on determining whether software deliverables in an arrangement that includes a tangible product are within the scope of the software revenue guidance. Concurrently, we adopted guidance that provides principles and application direction on whether multiple deliverables exist, how the arrangement should be separated, and the consideration allocated. It also requires an entity to allocate revenue in an arrangement using estimated selling prices of deliverables if a vendor does not have vendor-specific objective evidence (VSOE) or third-party evidence (TPE) of selling price. The guidance eliminates the use of the residual method, requires entities to allocate revenue using the relative-selling-price method and expands the disclosure requirements for multiple-deliverable revenue arrangements.

Under our current business practices, the new guidance will have an immaterial impact on our revenue accounting prospectively. Adoption of the new guidance does not require retroactive adjustment if adopted in the first quarter of a fiscal year. Revenue, income before income taxes, and net income in the prior year would not be impacted materially if the new guidance was applied; thus, our prior year consolidated financial statements are comparable to the current year.

Revenue from the sale of products that contain both software and nonsoftware components that function together to deliver a product s essential functionality is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is reasonably assured. Generally, 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 considered reasonably assured. For extended warranty 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 recognize licensing revenue using the proportional performance method, a ratable recognition approach over the life of the license.

Our sales arrangements may contain multiple elements, which include hardware and software products. In multiple-element arrangements, consideration is required to be measured and allocated among separate units of accounting. Our units of accounting include systems with software required for the essential functionality of the system, transducers, extended service contracts, software not essential to the functionality of our products, and training.

Consideration is allocated among the separate units of accounting based on their relative selling prices. The relative selling price is determined using VSOE of the selling price if it exists; otherwise, TPE of selling price, defined as the standalone sale price of a vendor s or competitor s products, would be used. If neither VSOE nor TPE exists, the best estimate of selling price for that deliverable is used.

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1. Summary of significant accounting policies (Continued)

Investment

Our investment is accounted for using the cost method as we own less than twenty percent of the voting equity and do not exercise significant influence over operating and financial policies of the entity. The company we invested in is not publicly traded and, therefore, no established market for their securities exists. The fair value of a cost method investment is not estimated if there are no identified events or changes in circumstance that may have a significant adverse affect on the fair value of the investment. If we believe that the carrying value of the cost basis investment is in excess of estimated fair value, our policy is to record an impairment charge to adjust the carrying value to estimated fair value, if the impairment is deemed other-than-temporary.

Inventories

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

Inventories consisted of the following (in thousands):

	As of	
	June 30, 2010	December 31, 2009
Raw material	$ 12,370	$ 9,224
Demonstration inventory	12,694	12,270
Finished goods	10,316	10,722
Total	$ 35,380	$ 32,216

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 NanoMaxx®, M-Turbo®, S Series®, MicroMaxx®, and BioZ® systems. Our warranty period for our other products and remanufactured systems is one year.

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

	Beginning of Period	Charged To Cost of Revenue	Liability from Acquistion	Applied to Liability	End of Period
Three months ended June 30, 2010	$ 8,700	$ 1,451	$ 130	$ (851)	$ 9,430
Three months ended June 30, 2009	$ 7,486	$ 1,041	$	$ (627)	$ 7,900
Six months ended June 30, 2010	$ 8,400	$ 2,568	$ 130	$ (1,668)	$ 9,430
Six months ended June 30, 2009	$ 7,094	$ 2,037	$	$ (1,231)	$ 7,900

Income taxes

The income tax provision for the three and six months ended June 30, 2010 is based on projections of total year pre-tax income and the projected total year tax provision. Deferred income taxes are provided based on the estimated future tax effects of temporary differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates that are expected to apply to taxable income in the years in which those temporary differences and carryforwards are expected to be recovered or settled.

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1. Summary of significant accounting policies (Continued)

Net income per share

Basic net income per share is based on the weighted average number of common shares outstanding during the period excluding shares repurchased by us but not yet settled as of the end of the period. Diluted net income per share is based on the weighted average number of common and dilutive common equivalent shares outstanding during the period. Potentially dilutive common equivalent shares consist of common stock issuable upon exercise of stock options and warrants, or upon vesting of restricted stock units using the treasury stock method. Diluted net income per share would also be impacted to reflect shares issuable upon conversion of our convertible senior notes if our share price exceeds $38.20 per share. Our call option on our shares is anti-dilutive and, therefore, excluded from the calculation of diluted net income per share.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net income	$ 1,875	$ 425	$ 3,258	$ 1,288
Basic weighted average common shares outstanding	14,601	17,219	15,438	17,150
Effect of dilutive stock options and restricted stock units	499	400	512	417
Diluted weighted average common shares outstanding	15,100	17,619	15,950	17,567
Net income per share:				
Basic	$ 0.13	$ 0.02	$ 0.21	$ 0.08
Diluted	$ 0.12	$ 0.02	$ 0.20	$ 0.07

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Stock options and restricted stock units	388	1,400	533	1,475
Warrants outstanding	1,122	1,184	1,122	1,184
Total common shares excluded from diluted net income per share	1,510	2,584	1,655	2,659

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

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1. Summary of significant accounting policies (Continued)

Other comprehensive income

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net income	$ 1,875	$ 425	$ 3,258	$ 1,288
Other comprehensive (loss) income:				
Foreign currency translation adjustment	(201)	(1,383)	(527)	(1,280)
Unrealized gains (losses) arising during the period	(11)	64	(17)	(104)
Comprehensive (loss) income	$ 1,663	$ (894)	$ 2,714	$ (96)

Indemnification obligations and guarantees (excluding product warranty)

We provide (i) indemnifications of varying scope and size to our customers and distributors against claims of intellectual property infringement made by third parties arising from the use of our products; (ii) indemnifications of varying scope and size to our customers arising as a result of defects in the design or manufacture of our products or as the result of willful misconduct of our employees; (iii) indemnifications of varying scope and size to consultants against third party claims arising from the services they provide to us; and (iv) guarantees to support obligations of some of our subsidiaries such as lease payments. Prior to the acquisition, CDIC had provided a reimbursement guarantee to certain customers that Medicare reimbursement would not be rescinded. These guarantees expire over the next five years.

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

2. Cash, cash equivalents and investment securities

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

	June 30, 2010	December 31, 2009
Cash	$ 12,145	$ 7,858
Cash equivalents:		
Corporate debt securities		13,999
Other debt obligations	32,331	161,208
Total cash and cash equivalents	$ 44,476	$ 183,065
Short-term investment securities:	$ 65,372	$ 74,682

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

Cash and cash equivalents primarily consist of money market accounts with major U.S. banks and highly liquid debt instruments with maturities at purchase of three months or less. Investment securities primarily consist of high-grade 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. Realized gains and losses from the sale of available-for sale securities are determined on a specific identification basis. All investment securities are traded in active markets (Level 1) and will mature by the end of the third quarter of 2010.

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

	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
As of June 30, 2010:				
Cash equivalents:				
Money market accounts	$ 32,331	$	$	$ 32,331
Total cash equivalents	$ 32,331	$	$	$ 32,331
Short-term investments:				
Corporate bonds	$ 65,375	$	$ 3	$ 65,372
As of December 31, 2009:				
Cash equivalents:				
Corporate debt securities	$ 13,996	$ 3	$	$ 13,999
Money market accounts	161,208			161,208
Total cash equivalents	$ 175,204	$ 3	$	$ 175,207
Short-term investments:				
Corporate bonds	$ 74,668	$ 18	$ (4)	$ 74,682

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Gains	$	$ 11	$	$ 13
Losses				(4)
Realized gain (loss), net	$	$ 11	$	$ 9

3. Investment

In March 2010, we invested $4.0 million in Carticept Medical Inc. (Carticept), a privately held company that develops innovative products for the treatment of musculoskeletal injuries. Concurrently, we entered a joint distribution arrangement with Carticept. If certain criteria are met by

September 2010, we are obligated to invest another $4.0 million. This investment is accounted for as a cost basis investment as we own less than 20% of the voting equity and do not have the ability to exercise significant influence. We will regularly evaluate the carrying value of this cost-method investment for impairment and whether any events or circumstances are identified that would significantly impair the fair value of the investment. No event has occurred that would adversely affect the carrying value of this investment.

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4. Stock repurchase

In June 2010, we repurchased 364,638 shares of our common stock in the open market for an aggregate price of $10.2 million, including shares repurchased but not yet settled at an average price of $27.75 per share. These repurchases were made using existing cash resources.

In March 2010, we repurchased 2,960,350 shares of our common stock at $30 per share for an aggregate price of $88.8 million. In connection with this stock repurchase, we incurred transaction costs of $1.2 million. This repurchase was made using existing cash resources. During the three months ended March 31, 2010, we also reclassified treasury stock of $0.1 million to retained earnings.

The following table summarizes the impact to equity related to the stock repurchases (in thousands):

	June 30, 2010	March 30, 2010
Shareholders equity:		
Common stock, $0.01 par value	$ (33)	$ (30)
Accumulated deficit	(100,177)	(90,016)
Total impact to shareholders equity	$ (100,210)	$ (90,046)

We have authorization from our board of directors to repurchase up to $150.0 million of our common stock or convertible debt. The repurchase program may be suspended or discontinued at any time without notice. As of June 30, 2010 the remaining amount that has been authorized to repurchase our common stock or convertible debt is $49.8 million.

5. Acquisitions

On June 30, 2010, we acquired all of the outstanding stock of VisualSonics, Inc. (VisualSonics), a leader in the development, manufacturing, and marketing of ultra high-resolution, ultrasound-based imaging technology (micro-ultrasound) designed to enable discovery research, medical diagnosis and imaging small physiological structures in humans and animals. VisualSonics micro-ultrasound product platform currently serves the pre-clinical research market. We intend to integrate VisualSonics micro-ultrasound technology with our miniaturization competency and user design to deliver ultra high-frequency micro-ultrasound into clinical medicine.

Cash consideration of $64.5 million was transferred for the shares of VisualSonics. Operating expenses include acquisition related charges of $2.5 million for the three and six months ended June 30, 2010.

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

	June 30, 2010
Assets	
Current assets:	
Cash and cash equivalents	$ 3,322
Accounts receivable	4,538
Inventories	5,002
Deferred income taxes	135
Prepaid expenses and other current assets	1,320
Total current assets	14,317
Property and equipment, net	1,312
Identifiable intangible assets	32,910

Goodwill	32,489
Total assets	$ 81,028
Liabilities	
Current liabilities:	
Accounts payable	$ 2,178
Accrued expenses and other current liabilities	3,277
Deferred revenue	410
Total current liabilities	5,865
Long-term debt	8,828
Deferred tax liabilities	1,424
Other non-current liabilities	371
Total liabilities	16,488
Net assets acquired	$ 64,580

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

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

	Amount	Amortization Period (in years)
Trademarks	$ 3,060	25
Developed technology	22,620	3 to 10
Customer relationships	7,230	5 to 7
Total intangibles	$ 32,910	

The total fair value of trade receivables acquired amounted to $4.5 million which equated the amount due on these receivables.

We recognized a warranty liability of $0.1 million related to VisualSonics products. We expect to incur the majority of these costs by the end of 2011. The potential undiscounted amount of all future payments that we could be required to make under the warranty arrangements is estimated to be $0.1 million.

We assumed long-term debt with an acquisition date fair value of $8.8 million which we repaid on June 30, 2010. As a result of our decision to repay the debt prior to its maturity we paid $0.1 million prepayment penalty which has been recorded as interest expense for the three and six months ended June 30, 2010.

We have not been able to complete the analysis of potential exposure to Federal, State, Local and International taxes. We are still gathering the information needed to determine whether a liability as of the acquisition date requires a provisional amount as part of the acquisition accounting. During the measurement period the provisional amount will be updated based upon new information received related to the facts and circumstances that existed at the acquisition date.

The results of VisualSonics operations were included in our condensed consolidated financial statements since the date of acquisition. Because the acquisition closed on June 30, 2010, our condensed consolidated statements of income for the three and six months ended June 30, 2010 do not include the results of operations of VisualSonics prior to the acquisition.

SonoSite assumed the equity awards granted on acquisition date under VisualSonics 2010 stock plan, accordingly, these unvested shares were converted into 345,689 unvested restricted stock units and 287,759 unvested stock options of SonoSite. The fair value of the equity awards of $9.4 million related to restricted stock units will be recognized as stock based compensation over a five year vesting period and $2.6 million related to stock options will be recognized as stock based compensation over a four year vesting period.

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In August 2009, we acquired all of the outstanding stock of CardioDynamics International Corporation (CDIC), a leader in impedance cardiography (ICG) for noninvasive hemodynamic assessment that develops, manufactures, and markets ICG devices and sensors. The ICG product line provides non-invasive assessment of cardiac output and other hemodynamic parameters. The business combination enables us to expand our distribution platform and product offerings into primary care. The results of CDIC s operations have been included in our consolidated financial statements since the date of acquisition.

For comparability purposes, the following table presents our pro forma revenue and earnings for the three and six months period ended June 30, 2009 and 2010, had the CDIC and VisualSonics acquisitions date been January 1, 2009 (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2010	June 30, 2009	June 30, 2010	June 30, 2009
Revenue	$ 69,260	$ 63,394	$ 133,174	$ 126,469
Net income (loss)	$ 330	$ (1,259)	$ 1,600	$ (2,130)
Net income (loss) per diluted share	$ .02	$ (.06)	$ .08	$ (.10)

Because VisualSonics fiscal year end is September, three months prior to our year-end, revenue and earnings (loss) in the pro forma disclosures have been adjusted to reflect our fiscal year. Additionally, VisualSonics earnings (loss) were adjusted to reflect the statutory tax rate utilized by VisualSonic in the pro forma periods presented. Pro forma earnings (loss) exclude non-recurring charges including acquisition costs, long-term debt, and liability classified equity instruments, but includes amortization of intangibles and share based compensation resulting from this acquisition.

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

6. Income tax expense

The income tax provision for the three and six months ended June 30, 2010 is based on projections of total year pre-tax income and the annual effective tax rate. The annual effective tax rate is applied to our ordinary worldwide pre-tax income. Discrete items are individually computed and recognized when the items occur. The following table summarizes our income tax provision (in thousands except percentages):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Income tax provision	$ 1,834	$ 257	$ 861	$ 782
Effective tax rate	49.4%	37.7%	20.9%	37.8%

The increase in our consolidated effective tax rate for the three months ended June 30, 2010 as compared to the same period in 2009 was due to the expiration of the U.S. research and development credit expiration after 2009 and non-deductible transaction costs, offset by the statutory increase in the domestic production activities deduction for 2010. The decrease in our consolidated effective tax rate for the six months ended June 30, 2010 as compared to the same period for 2009 resulted from a discrete benefit recorded in the period due to favorable resolution of uncertain tax positions upon completion of tax audits in our foreign jurisdictions and a decrease in rate due to the statutory increase in the domestic production activities deduction for 2010. This was offset by an increase in rate due to the expiration of the U.S. research and development credit expiration after 2009 and non-deductible transaction costs.

For the three and six months ended June 30, 2010 a valuation allowance of $0.4 million was recorded as part of the VisualSonics acquisition. There was no change to the valuation allowance recorded in 2009 of $1.5 million, which included a $1.2 million valuation allowance established against state NOL carryforwards acquired and a $0.3 million valuation allowance established against capital loss carryforwards

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7. Long-term debt

In July 2007, we completed the offering of $225.0 million aggregate principal amount of 3.75% convertible senior notes (Notes), which are due in 2014. The Notes may be converted, under certain circumstances described below, based on an initial conversion rate of 26.1792 shares of common stock per $1,000 principal amount of notes (which is equivalent to an initial conversion price of approximately $38.20 per share). The net proceeds from the issuance of the Notes were $217.6 million, after deducting debt issuance costs. The Notes have no restrictive covenants and the if-converted value is approximately equivalent to the current principal outstanding.

To account for the Notes, we bifurcated a component of the conversion option. We calculated the fair value of the liability component of the Notes using a discount rate of similar liabilities without conversion features and determined the carrying amount of the equity component by deducting the fair value of the liability component from the initial carrying value of the convertible debt. This resulted in an initial recognition of $63.9 million of debt discount, to be amortized over a seven year period at an effective interest rate of 8.5%, and a corresponding deferred tax liability of $23.6 million. Additionally, $2.1 million of debt issuance costs, which were included in other assets in our consolidated balance sheet, were classified as equity on a proportionate basis as the equity component.

The following table summarizes the carrying value of the debt and equity components (in thousands):

	As of	
	June 30, 2010	December 31, 2009
Senior convertible debt:		
Outstanding	$ 114,745	$ 114,745
Debt discount	(19,936)	(22,171)
Convertible senior notes, net	$ 94,809	$ 92,574
Equity component	$ 33,957	$ 33,957

The debt discount and debt issuance costs are being amortized through July 2014. Interest expense for the amortization of debt discount and debt issuance costs was $1.2 million for the three months ended June 30, 2010 and $2.4 million year to date. Interest expense for the contractual coupon was $1.1 million for the three months ended June 30, 2010 and $2.2 million for year to date. Interest expense related to the amortization of debt discount and debt issuance costs was $1.2 million and $2.6 million for the three and six months ended June 30, 2009. Interest expense related to the contractual coupon was $1.1 million and $2.4 million for the three and six months ended June 30, 2009.

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

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.

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7. Long-term debt (Continued)

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.

In connection with our purchase of CDIC, we acquired long-term debt. As of June 30, 2010, we had remaining long-term debt of $0.3 million, related to two bank loans, secured by the building acquired, with fixed interest rates of 5.9% and 5.3% through July 2011, when they become adjustable. Both loans mature on August 31, 2021.

Our long-term debt is measured for disclosure only at fair value using quoted market prices (Level 1). As of June 30, 2010, the fair value of our long-term debt was $115.3 million.

8. Hedging activities

We enter into derivative transactions to hedge certain foreign currency exposures. The currencies hedged are the British pound, the European Union euro, the Japanese yen, the Australian dollar and the Canadian dollar.

We utilize foreign currency forward contracts to offset foreign currency risk associated with our intercompany balances denominated in a currency other than the US Dollar on our balance sheet. These derivatives are not eligible for hedge accounting treatment. As of June 30, 2010, we had $51.6 million in notional amount of foreign currency forward contracts and $3.6 million in Canadian dollar (CAD) foreign currency forward contracts that expire through August 14, 2010. The fair value of these contracts as of June 30, 2010 was not material to our results of operations or financial position.

We also use various typles of foreign currency contracts to hedge the impact of foreign currency fluctuations on the translation of the financial statements of our foreign operations. As of June 30, 2010, we had $12.3 million in notional amount of USD denominated foreign currency contracts expiring at various dates through March 2011. These derivatives are not eligible for hedge accounting treatment.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Balance Sheet Hedges:				
Loss on foreign currency hedges	$ (1,197)	$ (3,166)	$ (2,105)	$ (751)
Gain on translation of intercompany receivables	700	2,884	1,385	818
Gain on foreign currency net income hedges	381		647	
Net (loss) gain related to hedge activities	$ (116)	$ (282)	$ (73)	$ 67

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9. Segment reporting

We have one reportable segment. We have integrated CDIC into our business and do not consider CDIC a separate reportable segment. We have not yet made any determination regarding VisualSonics as a separate reportable segment. We market our products in the United States and internationally through our direct sales force and our indirect distribution channels. Our chief operating decision maker evaluates resource allocation decisions and our performance based upon revenue recorded in geographic regions and does not receive financial information about expense allocation disaggregated by geographic regions. Geographic regions are determined by the shipping destination. Revenue by geographic location is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
United States	$ 32,156	$ 23,888	$ 56,971	$ 47,119
Europe, Africa and the Middle East	14,100	14,083	29,570	28,346
Latin America and Canada	4,830	5,280	9,510	10,049
Asia Pacific	10,463	9,034	21,475	18,576
Total revenue	$ 61,549	$ 52,285	$ 117,526	$ 104,090

10. Contingencies

In order to protect or enforce our patent rights, we may initiate patent litigation. Others may initiate patent litigation against us. We currently do not have any material outstanding claims that we have initiated or that have been initiated against us.

11. Accounting pronouncements issued not yet adopted

On January 4, 2010, the FASB issued Accounting Standards Update No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements (ASU 2010-06). ASU 2010-06 requires additional disclosure within the rollforward activity for assets and liabilities measured at fair value on a recurring basis, including transfers of assets and liabilities between Level 1 and Level 2 of the fair value hierarchy and the separate presentation of purchases, sales, issuances and settlements of assets and liabilities within Level 3 of the fair value hierarchy. In addition, ASU 2010-06 requires enhanced disclosures of the valuation techniques and inputs used in the fair value measurements within Level 2 and Level 3. ASU 2010-06 was adopted for the Company s first quarter ending March 31, 2010, except for the disclosure of purchases, sales, issuances and settlements of Level 3 measurements, for which disclosures are not required until the Company s first quarter of fiscal 2011. During the first and second quarter of fiscal 2010, the Company did not have any transfers of assets or liabilities between Level 1 and Level 2 of the fair value hierarchy. The adoption of the additional disclosures for Level 1 and Level 2 fair value measurements did not have an impact on the Company s financial position, results of operations or cash flows. The Company is currently evaluating the potential impact of the disclosures regarding Level 3 fair value measurements.

In March 2010, the Patient Protection and Affordable Care Act and the Health Care and Education Act of 2010 (the Acts) became law. Based on our preliminary review, the Acts do not appear to create any substantial, immediate costs. Because we do not subsidize our retiree medical plans and do not provide retirees with post-65 medical coverage, the elimination of the tax deduction related to the Medicare Part D subsidy in the Patient Protection and Affordable Care Act will not impact our consolidated financial statements. We are continuing to evaluate the impact, if any, of the Acts on our financial position and results of operations. Given the scope and complexity of the legislation and the fact that extensive implementing regulations remain to be promulgated, it is difficult to predict future impacts of the passage of this legislation.

As part of the health care reform provisions, a 2.3% tax will be imposed on the sale of taxable medical devices beginning in 2013. Like other taxes based on revenue-producing transactions, companies may elect to classify the excise tax in the income statement as an expense or a reduction of revenues. We expect to be subject to the excise tax and are currently evaluating the impact it will have on our business.

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

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

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

We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures we make on related subjects in our future quarterly reports on Form 10-Q, current reports on Form 8-K and annual reports on Form 10-K. Also note that we provide a cautionary discussion of risks, uncertainties and possibly inaccurate assumptions relevant to our business in Item 1A. Risk Factors section of our Annual Report on Form 10-K for the year ended December 31, 2009. These are risks that could cause our actual results to differ materially from those anticipated in our forward-looking statements or from our expected or historical results. Other factors besides the risks, uncertainties and possibly inaccurate assumptions described in this report could also affect actual results.

Overview

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

Our business strategy is to lead in the design, development and commercialization of high performance, innovative ultrasound technology and hand-cared ultrasound (HCU) systems. We intend to sustain long-term growth of our business through technological innovation, broadening of sales distribution channels, entering into and maintaining 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 are 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 through the expansion in four vertical markets including hospital, primary care, muscular skeletal, and field medicine. We will be 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 2010, we plan to continue to build on this foundation and to execute well in key areas, including continuing to innovate using existing and new technologies, to build and maintain key relationships in the sales distribution channels, to improve sales force productivity, to deliver high quality products, and to manage expenses.

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

On June 30, 2010 we acquired all of the outstanding stock of VisualSonics, Inc. (VisualSonics) a leader in high-frequency, high-resolution, ultrasound-based imaging systems (or micro-ultrasound systems) designed specifically for live imaging of small animals. The live imaging is a useful tool for life sciences research and for the pre-clinical stage of the drug development process. VisualSonics technology provides clinicians and research scientists with a simple method for viewing and quantifying extremely small physiological structures and for imaging living tissue with near-microscopic resolution. This business combination positions us for long-term growth in the clinical point-of-care markets in addition to the existing pre-clinical markets.

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 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. In fiscal year 2010

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we introduced Enhanced Needle Visualization, a significant development in ultrasound imaging that enables improved needle tracking with increased confidence during deep needle procedures. In fiscal year 2009, we introduced the NanoMaxx, which is based on our fourth generation product platform, and we acquired the BioZ product line from CDIC. Fiscal year 2010 will continue to see the release of new and innovative products.

Strategic Relationships and Acquisitions We are focused on building relationships and acquiring products and technologies that will enable us to continue to develop markets within ultrasound or with ultrasound-dependent technologies. We believe that new relationships, products, and technologies can accelerate market penetration to customers not served by our direct sales force. Through our acquisition of VisualSonics we intend to integrate micro-ultrasound technology with our miniaturization competency and user design to deliver ultra high-frequency micro-ultrasound into clinical medicine. During the second quarter of 2010 we announced an alliance with Physio-Control, Inc., the global leader in the development and delivery of emergency medical response solutions, for the development of the ultrasound in the emergency medical services ultrasound market. During the first quarter of 2010, we invested $4.0 million in Carticept Medical Inc. (Carticept), a privately held company that develops innovative products for the treatment of musculoskeletal injuries.

Expansion of Cardiovascular Disease Management (CVDM) and Vascular Access Markets We intend to maximize growth in CVDM through the introduction of new products, expansion of our sales force domestically and internationally. We also intend to expand our presence in the vascular market through the growth of sales of NanoMaxx, our most recently released product, and through the launch of our Lumenvu technology into the vascular access market.

Results of Operations

Our results of operations for the three and six months ended June 30, 2010 include operating results from CDIC, which was acquired in August 2009. The following financial information sets forth our results of operations and is derived from our condensed consolidated financial statements (in thousands except percentages):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2010		2009		2010		2009	
Revenue	$ 61,549	100.0%	$ 52,285	100.0%	$ 117,526	100.0%	$ 104,090	100.0%
Cost of revenue	17,195	27.9	15,299	29.3	33,475	28.5	32,012	30.8
Gross margin	44,354	72.1	36,986	70.7	84,051	71.5	72,078	69.2
Operating expenses:								
Research and development	7,211	11.8	7,375	14.1	14,808	12.6	15,072	14.5
Selling, general and administrative	30,996	50.3	27,584	52.8	60,425	51.4	53,387	51.3
License income and litigation settlement			(924)	(1.8)			(924)	(.9)
Total operating expenses	38,207	62.1	34,035	65.1	75,233	64.0	67,535	64.9
Operating income	6,147	10.0	2,951	5.6	8,818	7.5	4,543	4.4
Other loss	(2,438)	(4.0)	(2,269)	(4.3)	(4,699)	(4.0)	(2,473)	(2.4)
Income before income taxes	3,709	6.0	682	1.3	4,119	3.5	2,070	2.0
Income tax provision	1,834	3.0	257	0.5	861	0.7	782	0.8
Net income	$ 1,875	3.1 %	$ 425	0.8 %	$ 3,258	2.8 %	$ 1,288	1.2 %

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Revenue

Overall revenue increased for the three and six months ended June 30, 2010 compared to the three and six months ended June 30, 2009. The increase for the three months ended June 30, 2010 was primarily attributable to new revenue from primary care and U.S. direct sales, for the three months ended June 30, 2010. The increase for the six months ended June 30, 2010 was primarily attributable to new revenue from primary care and U.S. direct sales and a favorable foreign exchange rate of 1.8%. Revenue by geographic location is as follows (in thousands except percentages):

	Three Months Ended June 30,		Percentage Change 2010 to 2009	Six Months Ended June 30,		Percentage Change 2010 to 2009
	2010	2009		2010	2009	
Revenue:						
United States	$ 32,156	$ 23,888	34.6 %	$ 56,671	$ 47,119	20.3 %
Europe, Africa, and the Middle East	14,100	14,083	0.1	29,570	28,346	4.3
Latin America and Canada	4,830	5,280	(8.5)	9,510	10,049	(5.4)
Asia Pacific	10,463	9,034	15.8	21,475	18,576	15.6
Total revenue	$ 61,549	$ 52,285	17.7 %	$ 117,526	$ 104,090	12.9 %

United States

U.S. revenue for three months ended June 30, 2010 increased by 34.6% compared to the three months ended June 30, 2009 due primarily to 20% increase in direct sales and a 17.5% increase in primary care sales. U.S. Revenues for the six months ended June 30, 2010 increased by 20.3% compared to the six months ended June 30, 2009 due primarily to a 17% increase in direct sales and a 17.5% increase in primary care sales, offset by a 37% decline in enterprise sales.

International

Revenue from Europe, Africa and the Middle East for the three months ended June 30, 2010 marginally increased compared to the three months ended June 30, 2009 due to primary care sales. Changes in exchange rates had a 6.3% unfavorable impact on revenue for the three months ended June 30, 2010 as compared to the three months ended June 30, 2009. For the six months ended June 30, 2010 revenue increased 4.3% compared to the six months ended June, 2009 and was primarily due to primary care sales, increased sales in Italy offset by decreased sales in France, Germany and the UK. Changes in exchange rates had a 0.8% unfavorable impact on revenue for the six months ended June 30, 2010 as compared to the six months ended June 30, 2009.

Revenue from Latin America and Canada for the three months ended June 30, 2010 decreased by 8.5% compared to the three months ended June 30, 2009 due to decrease sales in both Canada and Latin America. Changes in exchange rates had a 1.9% favorable impact on revenue for the three months ended June 30, 2010 as compared to the three months ended June 30, 2009. For the six months ended June 30, 2010 revenue decreased by 5.4% compared to the six months ended June 30, 2009 due to decrease sales in Canada offset by increased sales in Latin America. Changes in exchange rates had a 4.4% favorable impact on revenue for the six months ended June 30, 2010 as compared to the six months ended June 30, 2009.

Revenue from Asia Pacific increased for the three months ended June 30, 2010 increased by 15.8% compared to the three months ended June 30, 2009 due to increased sales in all Asia Pacific markets. Changes in exchange rates had a 4.5% favorable impact on revenue for the three months ended June 30, 2010 as compared to the three months ended June 30, 2009. For the six months ended June 30, 2010 revenue increased by 15.6% compared to the six months ended June 30, 2009 primarily due to increased sales in Japan and Australia. Changes in exchange rates had a 6.7% favorable impact on revenue for the six months ended June 30, 2010 as compared to the six months ended June 30, 2009.

Fiscal Year 2010 Outlook

We expect revenue to increase between 18% and 19% with the inclusion of VisualSonics in 2010 compared to 2009. We expect to introduce new products and features, to develop the cardiovascular disease market, and to continue international expansion. Our revenue may be

negatively impacted by economic factors. The expansion of our four vertical markets including hospital, primary care, muscular skeletal, and field medicine, may not be as successful as anticipated and we may encounter regulatory and other issues in the approval and sale of our products. Introduction of new products may not be as successful as anticipated. Our revenue may also be impacted by fluctuations in foreign currency exchange rates in the countries in which we sell our products. Increased competition may also impact our anticipated revenue growth. We currently face competition from larger companies that manufacture cart-based and portable ultrasound systems and have greater financial and other resources.

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Gross margin

	Three Months Ended June 30,		Percentage of Revenue		Six Months Ended June 30,		Percentage of Revenue	
	2010	2009	2010	2009	2010	2009	2010	2009
Gross margin	$ 44,354	$ 36,986	72.1%	70.7%	$ 84,051	$ 72,078	71.5%	69.2%

Gross margin for the three months ended June 30, 2010 increased by 1.4% compared to the three months ended June 30, 2009 due to change in sales mix, license revenue, and a favorable foreign currency impact of approximately 0.2%. Gross margin for the six months ended June 30, 2010 increased by 2.3% compared to the six months ended June 30, 2009 due to change in sales mix, license revenue, and a favorable foreign currency impact of approximately 1.6%.

Fiscal Year 2010 Outlook

We expect gross margins with the inclusion of VisualSonics in 2010 to range between 70% and 71%. Increased competition from existing and new competitors as well as pricing pressure due to economic conditions could result in lower average realized prices which 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. Our gross margin may also be impacted by fluctuations in foreign exchange rates. Changes in our cost of inventory may also 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. Our cost to provide warranty services may increase if we experience an increase in failure rates or replacement costs differ from our estimates. 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 cost of revenue, a decrease in our gross margin or lost sales.

Operating expenses

	Three Months Ended June 30,		Percentage of Revenue		Six Months Ended June 30,		Percentage of Revenue	
	2010	2009	2010	2009	2010	2009	2010	2009
Research and development	$ 7,211	$ 7,375	11.8%	14.1%	$ 14,808	$ 15,072	12.6%	14.5%
Sales, general and administrative	$ 30,996	$ 27,584	50.3%	52.8%	$ 60,425	$ 53,387	51.4%	51.3%
License income and litigation settlement	$	$ (924)		(1.8)%	$	$ (924)		(0.9)%

Research and development expenses were $7.2 million for the three months ended June 30, 2010, compared to $7.4 million for the three months ended June 30, 2009. The decrease for the three months June 30, 2010 compared to the prior year was primarily attributable to reduced material costs and depreciation offset by increased payroll expenses. For the six months ended June 30, 2010 research and development expenses were $14.8 million compared to $15.1 million for the six months ended June 30, 2009. The decrease for the six months ended June 30, 2010 compared to the six months ended June 30, 2009 was primarily attributable to reduced material costs, stock based compensation and depreciation offset by increased payroll expenses.

Sales, general and administrative expenses were $31.0 million for the three months ended June 30, 2010, compared to $27.6 million for the three months ended June 30, 2009. The increase for the three months June 30, compared to the prior year was primarily attributable to acquisition costs, the addition of CDIC, intangibles amortization, offset by decreased professional fees. For the six months ended June 30, 2010 sales, general and administrative expenses were $60.4 million for the six months ended June 30, 2010, compared to $53.4 million for the six months ended June 30, 2009. The increase for the six months June 30, 2010 compared to the prior year was primarily attributable acquisition costs, the addition of CDIC, intangibles amortization, offset by decreased professional fees.

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License income and litigation settlement was $0.9 million for the three month and six months ended June 30, 2009 resulting from the settlement of patent dispute.

Fiscal Year 2010 Outlook

We anticipate that operating expenses will be higher in 2010 compared to 2009 due to acquisition costs and the additions of both CDIC and VisualSonics.

Other loss

	Three Months Ended June 30,		Percentage of Revenue		Six Months Ended June 30,		Percentage of Revenue	
	2010	2009	2010	2009	2010	2009	2010	2009
Other loss	$ 2,438	$ 2,269	(4.0)%	(4.3)%	$ 4,699	$ 2,473	(4.0)%	(2.4)%

Total other loss was $2.4 million for the three months ended June 30, 2010, compared to $2.3 million for the three months ended June 30, 2009. The increase for the three months June 30, 2010 compared to the prior year was lower interest income resulting from lower cash and investment balances offset by lower foreign exchange losses. Other losses were $4.7 million for the six months ended June 30, 2010, compared to $2.5 million for the six months ended June 30, 2009. The increase for the six months June 30, 2010 compared to the prior year was primarily attributable a gain on debt repurchase of $1.5 million recorded in the prior year, lower interest income resulting from lower cash and investment balances offset by lower foreign exchange losses.

Fiscal Year 2010 Outlook

We anticipate that other loss will increase in 2010 due to the gain on debt repurchase recorded in the prior year.

Income tax (benefit) expense

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Income tax provision	$ 1,834	$ 257	$ 861	$ 782
Effective tax rate	49.4%	37.7%	20.9%	37.8%

The income tax (benefit) 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 annual effective tax rate for the three months ended June 30, 2010 as compared to the same period in 2009 was due to the expiration of the U.S. research and development credit expiration after 2009 and non-deductible transaction costs, offset by the statutory increase in the domestic production activities deduction for 2010. The decrease in our annual effective tax rate for the six months ended June 30, 2010 as compared to the same period for 2009 resulted from a discrete benefit recorded in the period due to favorable resolution of uncertain tax positions upon completion of tax audits in our foreign jurisdictions and a decrease in rate due to the statutory increase in the domestic production activities deduction for 2010. This was offset by an increase in rate due to the expiration of the U.S. research and development credit expiration after 2009 and non-deductible transaction costs.

In the six months ended June 30, 2010, we recorded discrete tax benefits of $1.2 million related to favorable resolution of uncertain tax positions upon completion of tax audits in our foreign jurisdictions. The recording of these discrete items in the first six months of 2010 results in an overall year-to date effective tax rate of 20.9%.

Fiscal Year 2010 Outlook

We anticipate that our consolidated effective tax rate will be 40% for fiscal year 2010, however, if the research and development credit is reinstated by U.S. Congress during 2010, and we would expect the effective tax rate to decrease.

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Liquidity and Capital Resources

Our cash and cash equivalents balance was $44.5 million as of June 30, 2010, compared to $183.1 million as of December 31, 2009. Cash and cash equivalents were primarily invested in money market accounts. Our short-term investment securities totaled $65.4 million as of June 30, 2010, compared to $74.7 million as of December 31, 2009. Investment securities generally consist of 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.

Cash Flows

	Six Months Ended June 30,	
	2010	2009
Net cash provided by (used in):		
Operating activities	$ 21,313	$ 7,374
Investing activities	(57,693)	(1,140)
Financing activities	(103,442)	(19,883)
Effect of exchange rate changes on cash and cash equivalents	1,233	(1,743)
Net change in cash and cash equivalents	$ (138,589)	$ (15,392)

Operating activities provided cash of $21.3 million for the six months ended June 30, 2010, compared to $7.4 million for the six months ended June 30, 2009. The increase in operating cash flows for the six months ended June 30, 2010 compared to the six months ended June 30, 2009 was primarily attributable to a net increase in working capital offset by a decrease in noncash charges.

Investing activities used cash of $57.7 million for the six months ended June 30, 2010, compared to $1.1 million for the six months ended June 30, 2009. The decrease in cash provided by investing activities for the six months ended June 30, 2010 compared to June 30, 2009 was due primarily to our $61.2 million acquisition of VisualSonics and our $4.0 million investment in Carticept, partially offset by an increase in net cash provided by sales/maturities of investment securities.

Financing activities used cash of $103.4 million for the six months ended June 30, 2010, compared to $19.9 million for the six months ended June 30, 2009. The increase in cash used in financing activities for the six months ended June 30, 2010, compared to June 30, 2009, resulted primarily from $97.7 million in repurchases of our stock and the repayment of VisualSonic long-term debt of $8.8 million, compared to convertible debt repurchases of $20.5 million for the six months ended June 30, 2009.

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

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

any significant increase in our sales and marketing expenditures as a result of our introduction of new products; and

newly enacted health care reform provisions, such as the 2.3% excise tax imposed on the sale of taxable medical devices beginning in 2013.

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Critical Accounting Policies and Estimates

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

As discussed in Item 7, Management Discussion and Analysis of Financial Condition and Results of Operations of our annual report on Form 10-K for the year ended December 31, 2009, our critical accounting policies and estimates include revenue recognition, business combination, valuation of investments and inventories, warranty expense, income taxes, stock-based compensation, and convertible debt. There were no significant changes to these critical accounting policies during 2010 except as follows:

Revenue Recognition. On January 1, 2010, we adopted new revenue recognition accounting guidance, which removes tangible products from the scope of the software revenue guidance if the products contain both software and nonsoftware components that function together to deliver a product s essential functionality. It also provides guidance on determining whether software deliverables in an arrangement that includes a tangible product are within the scope of the software revenue guidance. Concurrently, we adopted guidance that provides principles and application direction on whether multiple deliverables exist, how the arrangement should be separated, and the consideration allocated. It also requires an entity to allocate revenue in an arrangement using estimated selling prices of deliverables if a vendor does not have vendor-specific objective evidence or third-party evidence of selling price. The guidance eliminates the use of the residual method, requires entities to allocate revenue using the relative-selling-price method and significantly expands the disclosure requirements for multiple-deliverable revenue arrangements.

Revenue from the sale of products that contain both software and nonsoftware components that function together to deliver a product s essential functionality is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is reasonably assured. Generally, 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 considered reasonably assured. For extended warranty 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 recognize licensing revenue using the proportional performance method, a ratable recognition approach over the life of the license.

Our sales arrangements may contain multiple elements, which include hardware and software products. In multiple-element arrangements, consideration is required to be measured and allocated among separate units of accounting. Our units of accounting include systems with software required for the essential functionality of the system, transducers, extended service contracts, software not essential to the functionality of our products, and training.

Consideration is allocated among the separate units of accounting based on their relative selling prices. The relative selling price is determined using vendor-specific objective evidence (VSOE) of the selling price if it exists; otherwise, third-party evidence (TPE) of selling price, defined as the standalone sale price of a vendor s or competitor s products, would be used. If neither VSOE nor TPE exists, the best estimate of selling price for that deliverable is used.

Revenue for software and software-related elements that are not essential to the functionality of a product and 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 VSOE of fair value for our undelivered 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.

Investment: We hold an investment in an entity where we own less than twenty percent of the voting equity and do not exercise significant influence over operating and financial policies of the entity is accounted for using the cost method. The evaluation of whether we exert

significant influence over the entity involves judgment considering the various terms of the arrangement. Our investment is in a company that is not publicly traded and, therefore, no established market for their securities

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exists. The fair value of a cost method investment is not estimated if there are no identified events or changes in circumstance that may have a significant adverse affect on the fair value of the investment. If we believe that the carrying value of an investment is in excess of estimated fair value, our policy is to record an impairment charge to adjust the carrying value to estimated fair value, if the impairment is deemed other-than-temporary.

Business Combination. In June 2010, we acquired all of the outstanding stock of VisualSonics. The purchase method of accounting was used to account for this acquisition. The cost of an acquisition is measured at the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date. Because the cost of acquisition is greater than the fair value of the net assets of the subsidiary acquired, the excess of the value of the purchase price over the net assets acquired has been recorded as goodwill. We recorded identifiable intangible assets including customer relationships, developed technology, and trademarks, which have lives from three to twenty-five years.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest rate risk

We are exposed to market risk relating to changes in interest rates, which could adversely affect the value of our investments in marketable securities.

As of June 30, 2010, our investment portfolio consisted of $65.4 million of interest-bearing debt securities with maturities of less than one year. Generally we have the ability to hold these securities until maturity; however, we have classified them as available-for-sale in the event of unanticipated cash needs. The interest bearing securities are subject to interest rate risk and will fall in value if market interest rates increase. We believe that the impact on the fair market value of our securities and related earnings for 2010 from a hypothetical 10% increase in market interest rates would not have a material impact on the investment portfolio.

Foreign currency risk

Because of our international presence, we are exposed to foreign currency risk on intercompany balances, from translation of our foreign subsidiaries operating results and in receivables due from customers denominated in a currency other than US dollar (USD). Our transactional and translational exposure is primarily related to the strengthening of the USD against the local currencies of our foreign subsidiaries and customers.

As of June 30, 2010, our intercompany balances denominated in a currency other than USD were $55.0 million. We enter into foreign currency forward contracts to reduce the impact of adverse fluctuations on earnings associated with foreign currency exchange rate changes. As of June 30, 2010, we had $51.6 million in notional amount of foreign currency forward contracts and $3.6 million in Canadian dollar (CAD) foreign currency forward contracts that expire through August 14, 2010. They serve as hedges of a substantial portion of our intercompany balances denominated in a currency other than the USD. These foreign currencies include the Australian dollar, the British pound, the Canadian dollar, the European Union euro, and the Japanese yen. Gains and losses in the fair value of these contracts are intended to offset the losses and gains, resulting from the changes in the underlying intercompany balances. The fair value of these contracts as of June 30, 2010 was not material to our results of operations or our financial position.

The operating results of our international subsidiaries are translated from their local currency into USD. Total sales for the six months ended June 30, 2010 denominated in a currency other than USDs were $39.4 million, or 34% of total consolidated revenues. The Australian dollar, the British pound, the European Union euro and the Japanese yen represented the majority of financial transactions executed in a currency not denominated in USDs. We use foreign currency forward contracts to hedge the impact of currency fluctuations on the translation of the financial statements of our foreign operations. As of June 30, 2010, we had $12.3 million in notional amount of foreign currency forward contracts expiring at various dates through December 31, 2010. The fair value of these contracts as of June 30, 2010 was not material to our results of operations or our financial position.

Our foreign currency forward contracts are not eligible for hedge accounting treatment and changes in the fair value of these derivatives are recorded in other income on the condensed consolidated statement of income. A sensitivity analysis of a change in the fair value of these contracts, totaling $63.9 million in notional amount and CAD $3.6 million, indicates that if the USD and CAD weakened by 10% against the applicable foreign currency, the fair value of these contracts would decrease by approximately USD $6.3 million and CAD $.4 million. Conversely, if the USD and CAD strengthened by 10% against the applicable foreign currency, the fair value of these contracts would increase

by approximately USD $6.4 million and CAD $.3 million. The offsetting gains and losses resulting from the changes in the intercompany balances as described above are not reflected in the sensitivity analysis above.

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We transact sales with international customers primarily in USD. We are exposed to risk of fluctuations in their local currency, which may impact our ability to collect amounts owed by them. As of June 30, 2010 65% of our outstanding accounts receivable balance was from international customers, of which 55.5%, or $20.7 million, was denominated in a currency other than 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.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

As of June 30, 2010, our chief executive officer and our chief financial officer have evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15 (e) and 15d-15 (e) of the Securities Exchange Act of 1934 (the Exchange Act), and they have concluded that our disclosure controls and procedures were effective to ensure that the information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

Changes in internal control over financial reporting

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

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

We currently do not have any material outstanding claims that we have initiated or that have been initiated against us.

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.

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

On June 30, 2010, we acquired all of the outstanding stock of VisualSonics, Inc. (VisualSonics), a leader in the development, manufacturing, and marketing of ultra high-resolution, ultrasound-based imaging technology (micro-ultrasound) designed to enable discovery research, medical diagnosis and imaging small physiological structures in humans and animals. VisualSonics micro-ultrasound product platform currently serves

the pre-clinical research market.

On August 14, 2009, we acquired all of the outstanding stock of CDIC, a leader in ICG for noninvasive hemodynamic assessment that develops, manufactures, and markets ICG devices and sensors. The ICG product line provides non-invasive assessment of cardiac output and other hemodynamic parameters.

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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 or 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 acquisition or integration related charges. If we fail in our attempts to integrate any acquired business or technology, or if the business fails to meet our forecasts, our financial resources or financial results could be negatively 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 ultrasound 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 or more restrictive payment for ultrasound services. Additionally, some private insurers have implemented imaging privileging 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.

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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.

In October 2009, we resolved all pending patent litigation with GE. Under the terms of the settlement, GE made an up front royalty payment to SonoSite of $21 million and will pay an ongoing royalty on U.S. sales and production of hand-carried ultrasound systems in exchange for a non-exclusive perpetual, nontransferable worldwide license to the 412 patent. We may face increasing competition as a result of this settlement.

Unfavorable economic conditions may have an adverse impact on our business.

Unfavorable changes in economic conditions, including inflation, recession, or other changes in economic conditions, may result in lower consumer healthcare spending as well as physician and hospital spending and availability of credit. If demand for medical devices or budgets for capital improvements decline, our revenue could be adversely affected. 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 could result in sales disruption.

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.

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 services, 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, could revise their payment methodologies and impose stricter standards for reimbursement of imaging procedures charges and/or a lower or more bundled payment;

- the recently passed Patient Protection and Affordable Health Care Act (A.R. 3590) and the Health Care and Education Reconciliation Act (H.R. 4872) includes an excise tax on medical device manufacturers designed to raise $20 billion over ten years. Unless this tax is repealed, beginning in January of 2013 medical device manufacturers will be required to pay 2.3% of U.S. revenue to meet their obligation. Other aspects of healthcare reform legislation, such as reductions in reimbursements to hospitals may dampen demand for our products.

- 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.

Failure to develop and innovate new products and product features could adversely affect our business and negatively impact future revenues.

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 2009, 2008 and 2007, we released several new products, including the NanoMaxx ultrasound tool, 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

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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 develop and introduce these products. Without successful product innovation and market introduction of new product offerings and feature improvements, our products will become technologically obsolete and we will be unable to compete effectively in the ultrasound market. Additionally, we may be unable to create or introduce new products or features in the CVDM market or any new markets that we may enter. Even with successful innovation and development, we cannot assure you that revenues will continue to remain at or above current levels or that we will continue to be financially profitable.

Because technological 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 product development projects include:

- research and development challenges;
- lack of technological expertise outside of ultrasound;
- 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 markets that we serve and could adversely affect our operating results.

We could experience production delays, cost increases, and lost sales if our suppliers fail to supply components on a timely basis or if we are required to switch suppliers.

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 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 product sales could be substantially reduced.

In addition, our circuit boards are produced in Malaysia 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 resulting in lost sales or an increase in costs, which could cause deterioration in gross margin.

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. 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.

Increased reliance on group purchasing organizations and U.S. governmental agencies may lead to pressure on pricing and increased competition.

We depend on group purchasing organizations and U.S. governmental agencies for significant revenues. These groups represent 72% of our U.S. revenues. These agreements are complex, include contractual pricing limitations, fees and span multi-years. These agreements provide access to customers and contain provision related to pricing, usage, cost-effectiveness, and use of competitor products. This enhanced purchasing power may also lead to pressure on pricing and increased use of preferred vendors. In addition, our status as a U.S. government contractor requires us to comply with numerous laws and regulations. We intend to continue to expand use of these contracts and negotiate renewals of existing agreements However if we do not manage the relationship effectively, renew with satisfactory terms or fulfill the contractual and legal requirements with the group purchasing organizations and U.S. governmental agencies, our ability to sell to them and our results could be adversely affected.

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We derive a significant portion of our revenue from foreign sales and are subject to the risks of doing business in other countries.

We have eleven 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 54%, 51% and 49% for the years ended December 31, 2009, 2008 and 2007, 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.

The international sale and shipment of our products subject us to extensive United States and foreign governmental trade regulations. Failure to comply with any legal and regulatory obligations could impact us in ways including, but not limited to, denial of export privileges, criminal, civil, and administrative penalties, fines, seizure of shipments, and restrictions on certain business activities.

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 and difficult to control. In addition, we may be subject to the following conditions in countries where we conduct our operations:

- changes or uncertainties in economic, legal, regulatory, social and political conditions in the Company s markets;
- 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 impact our operating results.

Fluctuations in foreign currency exchange rates could result in declines in our reported revenue and earnings.

Total sales denominated in a currency other than USD were $39.4 million, or 34% of our total consolidated revenue and total expenses denominated in a currency other than USD were $17.5 million or 23% of our total consolidated operating expenses for the year ended June 30, 2010. As a result, our results of operations could be adversely affected by certain movements in exchange rates. Although we take steps to hedge a portion of our net 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 June 30, 2010, 65% of our accounts receivable balance was from international customers, of which 55.5%, or $20.7 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.

If we, or our suppliers, are unable to obtain timely U.S. and foreign governmental regulatory approvals 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.

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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.

Failure to sustain profitability, grow, or manage our growth could impair our ability to achieve our business objectives.

For the first 6 months of 2010, our revenue increased to $117.5 million from $104.0 million. We intend to continue to grow our business; however, we may be unable to sustain or increase our revenue or profitability on a quarterly or annual basis. We may incur losses if we cannot increase or sustain our revenue. Additionally, operating expenses would increase if we pursue acquisitions of companies or technologies to further our growth.

Future growth could strain our existing management, operational and financial resources and, if we are unable to manage this growth successfully and retain or attract qualified personnel, our business and financial performance will be adversely affected. In order to manage our growth effectively, we will need to improve the productivity and efficiency of our existing sales, manufacturing, operational, administrative, and 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.

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.

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

Our corporate headquarters and 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 information data center and certain manufacturing equipment would be difficult to replace and could require substantial replacement lead-time. Such catastrophic events may also destroy any inventory of product or components and information systems. 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.

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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 2007, we initiated a lawsuit against Zonare 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. In 2009, we settled all pending patent litigation worldwide with GE. 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.

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.

We may not be able to protect our intellectual property rights.

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 76 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.

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 NanoMaxx and S Series ultrasound tools and the M-Turbo, MicroMaxx and BioZ systems. 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.

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Our business objectives and financial results depend on our ability to attract and retain talented employees.

Our success depends heavily on our ability to attract and 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.

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 year-end and quarterly 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.

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

Our cash and cash equivalents, and investments made up over 33% of our total assets as of June 30, 2010 and 50% of our total assets as of December 31, 2009, during which credit and capital markets deteriorated and resulted in impairments on our investment in the Columbia Strategic Cash Portfolio, an investment that was fully liquidated in 2009. Although our holdings are liquid, economic factors could impact the liquidity of our portfolio and result in additional impairments to our investment portfolio, which could negatively affect our financial condition, cash flow and reported earnings.

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 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.

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

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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.

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.

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.

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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.

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

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Item 6. Exhibits

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

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SIGNATURE

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

SONOSITE, INC.

(Registrant)

Dated: August 9, 2010

By: /s/ MICHAEL J. SCHUH
Michael J. Schuh
Vice President, Chief Financial Officer and Treasurer
(Authorized Officer and Principal Financial Officer)