SONOSITE INC
Form 10-Q
August 13, 2002
Table of Contents

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, 2002

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 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	**14,081,613**
(Class)	(Outstanding as of August 12, 2002)

Table of Contents

SonoSite, Inc.

Quarterly Report on Form 10-Q
For the Quarter Ended June 30, 2002

Table of Content s

Table of Contents

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

SonoSite, Inc.

Condensed Consolidated Balance Sheets
(unaudited)

	June 30, 2002	December 31, 2001
	(In thousands, except share data)	
Assets		
Current assets:		
Cash and cash equivalents	$ 71,693	$ 33,116
Accounts receivable, less allowance for doubtful accounts of $768 and $932	14,002	14,003
Inventories	8,644	8,299
Prepaid expenses and other current assets	1,329	1,017
Total current assets	95,668	56,435
Property and equipment, net	5,873	5,685
Receivable from affiliate		188
Other assets	800	870
Total assets	$ 102,341	$ 63,178
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 2,698	$ 1,914
Accrued expenses	4,592	3,816
Current portion of long-term obligations	356	131
Deferred revenue	1,973	1,248
Total current liabilities	9,619	7,109
Deferred rent	224	201
Long-term obligations, less current portion	60	185
Total liabilities	9,903	7,495
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, 2002 14,077,262		
As of December 31, 2001 11,363,231	141	114
Additional paid-in-capital	176,163	133,470
Accumulated deficit	(84,062)	(77,901)

Accumulated other comprehensive income	196	
Total shareholders equity	92,438	55,683
Total liabilities and shareholders equity	$ 102,341	$ 63,178

See accompanying notes to condensed consolidated financial statements.

Table of Contents

SonoSite, Inc.

Condensed Consolidated Statements of Operations
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(In thousands, except loss per share)			
Revenue	$ 16,600	$ 10,283	$ 29,443	$ 18,446
Cost of revenue	6,944	5,325	12,339	10,191
Gross margin	9,656	4,958	17,104	8,255
Operating expenses:				
Research and development	3,095	3,231	6,343	6,786
Sales and marketing	7,715	5,523	14,046	11,055
General and administrative	1,424	957	2,914	2,086
Total operating expenses	12,234	9,711	23,303	19,927
Other income (loss):				
Interest income	173	62	295	450
Interest expense	(42)	(36)	(80)	(69)
Equity in losses of affiliates	(43)	(16)	(177)	(177)
Loss on investments		(290)		(290)
Total other income (loss)	88	(280)	38	(86)
Net loss	$ (2,490)	$ (5,033)	$ (6,161)	$ (11,758)
Basic and diluted net loss per share	$ (0.20)	$ (0.52)	$ (0.51)	$ (1.23)
Weighted average common and potential common shares used in computing net loss per share	12,623	9,623	12,001	9,595

See accompanying notes to condensed consolidated financial statements.

Table of Contents

SonoSite, Inc.

Condensed Consolidated Statements of Cash Flows
(unaudited)

	Six Months Ended June 30,	
	2002	2001
	(In thousands)	
Operating activities:		
Net loss	$ (6,161)	$ (11,758)
Adjustments to reconcile net loss to net cash used in operating activities:		
Loss on investments		290
Depreciation and amortization	1,228	1,200
Equity in loss of affiliates	177	177
Changes in operating assets and liabilities:		
Accounts receivable	207	(3,095)
Receivable from affiliates	26	(101)
Inventories	(294)	5,093
Prepaid expenses and other current assets	(235)	760
Other assets	(45)	(360)
Accounts payable	784	(3,715)
Accrued expenses	494	(473)
Deferred liabilities	748	345
Net cash used in operating activities	(3,071)	(11,637)
Investing activities:		
Purchase of investments		(2,573)
Proceeds from maturities of investments		12,604
Purchase of equipment	(1,329)	(718)
Net cash provided by (used in) investing activities	(1,329)	9,313
Financing activities:		
Proceeds from sale of common shares	42,885	
Repayment of long-term obligations	(64)	(286)
Exercise of stock options	102	617
Net cash provided by financing activities	42,923	331
Effect of exchange rate changes on cash and cash equivalents	54	
Net change in cash	38,577	(1,993)
Cash and cash equivalents at beginning of period	33,116	11,067
Cash and cash equivalents at end of period	$ 71,693	$ 9,074
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 80	$ 42

Supplemental disclosure of non-cash investing and financing activities:

Offering costs included in accrued expenses	$	267	$	

See accompanying notes to condensed consolidated financial statements.

5

Table of Contents

SonoSite, Inc.

Notes to Condensed Consolidated Financial Statements
(unaudited)

Interim Financial Information

The information contained herein has been prepared in accordance with instructions for Form 10-Q and Article 10 of Regulation S-X. The information furnished 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 period presented. The results of operations for the three months and six months ended June 30, 2002 are not necessarily indicative of our expected results for the entire year ending December 31, 2002 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, 2001, included in our most recent Annual Report on Form 10-K/A. Certain amounts reported in previous periods have been reclassified to conform to current presentation.

Financial Instruments

Cash equivalents

Cash equivalents consist of money market and highly liquid debt instruments with original or remaining maturities at purchase of three months or less.

Accounts receivable

In the ordinary course of business, we grant credit to a broad customer base. Of the accounts receivable balance at June 30, 2002, 50% were receivable from international parties and 50% were receivable from domestic parties, prior to any allowance for doubtful accounts, of which approximately $487,000 was included in other long-term assets. The same percentages as of December 31, 2001 were 58% and 42% prior to any allowance for doubtful accounts, of which approximately $283,000 was included in other long-term assets.

For the three months ended June 30, 2002, revenue was 61% domestic and 39% international, compared to 55% domestic and 45% international for the three months ended June 30, 2001. For the six months ended June 30, 2002, revenue was 57% domestic and 43% international, compared to 50% domestic and 50% international for the six months ended June 30, 2001.

The following tables present an individual customer whose outstanding receivable balance as a percentage of total trade receivables and/or revenue as a percentage of total revenue exceeded 10%:

Accounts Receivable:

	June 30, 2002	December 31, 2001
Japanese distributor	12%	28%

Revenue:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Japanese distributor	10%	13%	10%	14%

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Fair value of financial instruments

The carrying value of our financial instruments, including cash and cash equivalents, accounts receivable, certain long-term other assets and debt, approximates fair value. Cash and cash equivalents and accounts receivable approximate fair value due to their short-term nature. Long-term other assets and debt approximate fair value as interest rates on these notes approximate market.

Table of Contents

Inventories

Inventories are stated at the lower of standard cost, which approximates actual cost on a first-in, first-out method, or market. Included in our inventories balance are demonstration products used by our sales representatives and marketing department, and items that have been shipped to customers for which revenue recognition requirements have not been met, including products whose title and custody have passed to the customer. Adjustments to cost are recorded for obsolete material, earlier generation products and refurbished product held either as saleable inventory or as demonstration product if necessary to reduce their carrying values to amounts which will result in approximately normal profit margins upon sale. Inventory items for which title has passed to customers are evaluated for recoverability based on the same process we use to evaluate collection of accounts receivable. If market conditions are less favorable than those projected by management, additional downward inventory cost adjustments may be required.

Inventories consist of the following (in thousands):

	As of	
	June 30, 2002	December 31, 2001
Raw material	$ 3,097	$ 3,915
Demonstration inventory	2,094	1,789
Finished goods	3,453	2,595
Total	$ 8,644	$ 8,299

At June 30, 2002, finished goods includes approximately $0.6 million of inventory whose title has passed to the customer and for which revenue has not yet been recognized, and at December 31, 2001, finished goods includes approximately $0.8 million of inventory whose title has passed to the customer and for which revenue has not yet been recognized.

Property and equipment

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

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

Asset	Estimated Useful Lives
Equipment, other than computer	5-7 years
Software	3 years
Computer equipment	3-5 years
Furniture and fixtures	5 years
Leasehold improvements	Lesser of estimated useful life or expected remaining lease term

Direct internal and external costs for computer software developed for internal use are capitalized in accordance with SOP 98-1, Accounting for Costs of Computer Software Developed or Obtained for Internal Use. Capitalized costs are amortized using the straight-line method over the estimated useful lives beginning when each module is complete and ready for use. Such costs are insignificant for all periods presented.

The carrying value of long-lived assets is evaluated for impairment when events or changes in circumstances occur, which may indicate the carrying amount of the asset may not be recoverable. We evaluate the carrying value of the assets by comparing the estimated future cash flows generated from the use of the asset and its eventual disposition with the assets reported net book value.

Concentration of credit and supply risk

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

We depend on some single-source suppliers to provide highly specialized parts and other components. We do not intend to maintain significant inventories of components, and may experience an interruption of supply if a supplier is unable or unwilling to meet our time, quantity and quality requirements. There are relatively few alternative sources of supply for some of these items. An increase in demand for some parts by other companies in our industry could also interrupt our supply of components.

Table of Contents

Accumulated Other Comprehensive Income (Loss)

Other comprehensive loss consists of net unrealized losses on investments and translation adjustments for fluctuations in currency exchange rates.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Net loss	$ (2,490)	$ (5,033)	$ (6,161)	$ (11,758)
Other comprehensive income (loss):				
Foreign Currency Translation adjustment	239		196	
Unrealized holding losses arising during the period		(137)		(248)
Less reclassification adjustment for losses included in net loss		290		290
Comprehensive loss	$ (2,251)	$ (4,880)	$ (5,965)	$ (11,716)

Net Loss per Share

Basic and diluted net loss per share was computed by dividing the net loss by the weighted average common shares outstanding exclusive of unvested restricted shares. Outstanding options to purchase our shares and our unvested restricted shares were not included in the computations of diluted net loss per share because to do so would be antidilutive. As of June 30, 2002, our outstanding options totaled 2,954,087. There were no unvested restricted shares remaining as of June 30, 2002 and approximately 1,000 at the end of June 30, 2001. As of June 30, 2001, our outstanding options and unvested restricted shares totaled 2,571,703.

Subsequent to June 30, 2002, our board of directors on July 25, 2002 approved an additional 250,000 shares available for issuance under the SonoSite, Inc. 1998 Nonofficer Employee Stock Option Plan, or NOE Plan.

Foreign Currency Translation

The functional currencies of our international subsidiaries are the local currency of the country in which the subsidiary is located. Assets and liabilities denominated in foreign currencies are translated at the exchange rate on the balance sheet date. Net revenues, costs and expenses of international operations are translated at average rates of exchange prevailing during the period. Realized and unrealized gains and losses on currency transactions were immaterial in all periods presented.

Litigation

On July 24, 2001, Neutrino Development Corporation filed a complaint against us in U.S. District Court, Southern District of Texas, Houston Division, alleging infringement of U.S. Patent 6,221,021 by SonoSite as a result of our use, sale and manufacture of the SonoSite 180, SonoSite 180 PLUS, SonoHeart and SonoHeart PLUS devices. The complaint asserts claims for preliminary and permanent injunctive relief enjoining all alleged acts of infringement, compensatory and enhanced damages, attorney s fees and costs, and pre- and post-judgment interest. On August 14, 2001, we filed an answer asserting alternative defenses of non-infringement and patent invalidity, and including a counterclaim seeking a declaratory judgment of non-infringement and invalidity regarding Neutrino s patent. On October 4, 2001, the court denied a request by Neutrino for preliminary injunctive relief to prevent us from manufacturing and selling our products pending the ultimate disposition of the litigation. On February 20, 2002, in what is known as a Markman hearing, the parties presented their arguments regarding the proper construction of Neutrino s patent claims. The court has not yet ruled on the issues presented in that hearing. We believe we have good and sufficient defenses to the claims of patent infringement asserted against us by Neutrino and we are vigorously defending ourselves in this matter.

Table of Contents

Segment Reporting

We currently have one operating segment. Geographic regions are determined by the shipping destination. Revenue by geographic location and segregated between distributor and direct sales in the United States is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	**2001**	**2002**	**2001**
United States direct	$ 9,679	$ 5,012	$ 15,950	$ 8,048
United States distributor	392	621	689	1,191
Total United States	10,071	5,633	16,639	9,239
Japan	1,678	1,203	3,056	2,389
Europe, Africa and the Middle East	2,786	1,829	5,901	4,448
Canada, South and Latin America	760	1,149	1,891	1,464
Other Asia (a)	1,305	469	1,956	906
Total revenue	$ 16,600	$ 10,283	$ 29,443	$ 18,446

(a) Other Asia primarily includes China, Korea, and Taiwan.

New Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board (FASB), issued Statement of Financial Accounting Standard No. 141, Business Combinations, and Statement No. 142, Goodwill and Other Intangible Assets. Statement No. 141 requires that all business combinations be accounted for under a single method the purchase method. Use of the pooling-of-interest method is no longer permitted. Statement 141 requires that the purchase method be used for business combinations initiated after June 30, 2001. Statement 142 requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. The amortization of goodwill ceases upon adoption of the statement, which was adopted by us on January 1, 2002. The adoption of this statement did not have a material impact on our financial statements.

In August 2001, the FASB issued Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which supersedes Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of. Statement No. 144 retains many of the fundamental provisions of Statement No. 121 and provides a single method of accounting for long-lived assets to be disposed of. We adopted the provisions of Statement No. 144 for the fiscal year beginning January 1, 2002. The adoption of this statement for long-lived assets held for use did not have any impact on our financial statements. The provisions of the statement for assets held for sale or other disposal generally are required to be applied prospectively after the adoption date to newly initiated disposal activities. Therefore, we cannot determine the potential future effects that the adoption of this statement for assets held for sale or other disposal will have on our financial statements.

In July 2002, the FASB issued Statement No. 146, Accounting for Costs Associated with Exit or Disposal Activities , which addresses financial accounting and reporting for costs associated with exit or disposal activities. Statement No. 146 nullifies EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) . The principal difference between Statement No. 146 and Issue No. 94-3 relates to the recognition of a liability for a cost associated with an exit or disposal activity. Statement No. 146 requires that a liability be recognized for those costs only when the liability is incurred, that is, when it meets the definition of a liability in the FASB s conceptual framework. In contrast, under Issue No. 94-3, a company recognized a liability for an exit cost when it committed to an exit plan. Statement No. 146 also establishes fair value as the objective for initial measurement of liabilities related to exit or disposal activities. The Statement is effective for exit or disposal activities that are initiated after December 31, 2002 although earlier application is encouraged. We do not expect the adoption of this statement will have a material impact on our financial statements.

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 include statements about our plans, objectives, expectations and intentions and other statements that are not historical facts. Words such as believe, anticipate, expect and intend may identify forward-looking statements, but the absence of these words does not necessaril y 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 under the caption Important Factors That May Affect Our Business, Our Results of Operations and Our Stock Price in this report. These are risks that we think 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.

Table of Contents

Overview

We are a leading provider of high performance, highly miniaturized, hand-carried, all-digital ultrasound imaging devices for use in a variety of clinical applications and settings. Our proprietary technologies have enabled us to design hand-carried diagnostic ultrasound devices that combine all-digital, high resolution imaging with advanced features and capabilities traditionally found on cart-based ultrasound systems. We believe that the portability, high quality and cost effectiveness of our products are expanding existing markets and will create new markets for ultrasound imaging by:

- bringing ultrasound out of the imaging center to the patient s bedside or the physician s examining table; and

- enabling physicians to conduct an imaging physical by incorporating ultrasound imaging into routine physical examinations.

The size and complexity of traditional ultrasound systems typically compel physicians to refer patients to a highly trained sonographer employed by an imaging center, such as a hospital s radiology department. By providing ultrasound at the primary point of care, our hand-carried, easy-to-use devices can eliminate delays associated with the referral process and enable physicians to use ultrasound more frequently and in a wider variety of clinical settings. This increased accessibility creates the potential for enhanced patient care through earlier diagnosis of diseases and conditions.

We currently focus on six key market segments: radiology, obstetrics and gynecology, emergency medicine, surgery, cardiology and vascular medicine. Our current products include the SonoSite 180PLUS, for general ultrasound imaging, and the SonoHeart ELITE, specifically configured for cardiovascular applications. These products are used together with any of our six interchangeable handheld components, or transducers, that are designed for specific clinical applications.

On June 20, 2002, we announced that we had received 510(k) clearance from the U.S. Food and Drug Administration, or FDA, for our new iLook platform. We expect to commence sales efforts of the iLook late in the third quarter of 2002.

We were formerly the handheld ultrasound device division of ATL Ultrasound, Inc., or ATL. On April 6, 1998, we were spun off as an independent, publicly owned Washington corporation to further the development and commercialization of high performance, highly miniaturized, hand-carried, all-digital ultrasound imaging devices. ATL retained no ownership in us following the spin-off. Under an agreement with ATL, we hold a five-year exclusive license to use any ATL ultrasound technology existing at the time of the spin-off, or created by ATL during the three years following the spin-off, in ultrasound devices weighing 15 pounds or less. On April 6, 2003, this license becomes nonexclusive and, except for ATL patented technology or registered software, will extend to use in ultrasound devices weighing more than 15 pounds. We sold our first products in September 1999.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues 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.

We believe the following critical accounting policies require our more significant judgments and estimates used in the preparation of our consolidated financial statements:

Revenue recognition. We recognize revenue on products and accessories when goods are shipped under an agreement with a customer, risk of loss and title have passed to the customer and collection of any resulting receivable is reasonably assured. For service contracts, revenue is recognized over the term of the contract. Sales discounts are recorded as a reduction in revenue.

In connection with sales to certain specific international customers, we sometimes conclude that full collection of the related accounts receivable is not reasonably assured due to extended payment terms or the financial condition of our customer and, consequently, we do not recognize revenue or cost of revenue at the time of title transfer. In instances where collection is not

Table of Contents

reasonably assured, revenue and cost of revenue are recorded when cash is received. Additionally, in cases of nonstandard delivery and acceptance criteria, we will not recognize revenue at shipment, but rather when the delivery and acceptance criteria have been satisfied.

Valuation of inventories. Inventories are stated at the lower of standard cost, which approximates actual cost on a first-in, first-out method, or market. Included in our inventories balance are demonstration products used by our sales representatives and marketing department and items that have been shipped to customers for which revenue recognition requirements have not been met. Cost adjustments are recorded for obsolete material, earlier generation products and used product held either as saleable inventory or as demonstration product, if necessary to reduce their carrying values to amounts which will result in approximately normal profit margins upon sale. Inventory items for which title has passed to customers are evaluated for recoverability based on the same process we use to evaluate collection of accounts receivable.

We make judgments regarding the carrying value of our inventory based on current market conditions. Market conditions may change depending upon competitive product introductions, consumer demand and reimbursement criteria in the medical community. If market conditions change or if the introduction of new products by us impacts the market for our previously released products we may be required to write-down the cost of our inventory.

Results of Operations

Revenue

Revenue increased to $16.6 million and $29.4 million for the three months and six months ended June 30, 2002, compared to $10.3 million and $18.4 million for the three months and six months ended June 30, 2001. The increase was primarily due to an increase in sales in the United States resulting from an increase in U.S. direct sales representatives.

The following represents revenue by region:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
United States direct	58%	49%	54%	44%
United States distributor	3%	6%	3%	6%
Total United States	61%	55%	57%	50%
Japan	10%	12%	10%	13%
Europe, Africa and the Middle East	17%	18%	20%	24%
Canada, South and Latin America	4%	11%	6%	8%
Other Asia (a)	8%	4%	7%	5%
Total revenue	100%	100%	100%	100%

(a) Other Asia primarily includes China, Korea, and Taiwan.

Total U.S. revenue increased to $10.1 million and $16.6 million, or 61% and 57% of total revenue, for the three months and six months ended June 30, 2002, compared to $5.6 million and $9.2 million, or 55% and 50% of total revenue, for the three months and six months ended June 30, 2001, due to our new product introductions and increased selling efforts. Within the United States, direct sales increased to $9.7 million and $16.0 million, or 58% and 54% of total revenue, for the three months and six months ended June 30, 2002, compared to $5.0 million and $8.0 million, or 49% and 44% of total revenue, for the three months and six months ended June 30, 2001, due to the increase in U.S. direct sales representatives. With our transition to a direct sales force, distributor sales in the United States decreased to $392,000 and $689,000, or 3% of total revenue, for the three months and six months ended June 30, 2002 compared to $621,000 and $1.2 million, or 6% of total revenue, for the three months and six months ended June 30, 2001.

Revenue from Japan increased to $1.7 million and $3.1 million, or 10% of total revenue, for the three months and six months ended June 30, 2002, compared to $1.2 million and $2.4 million, or 12% and 13% of total revenue, for the three months and six months ended June 30, 2001, due to an increase in orders from our distributor in Japan.

Revenue from Europe, Africa and the Middle East increased to $2.8 million and $5.9 million, or 17% and 20% of total revenue, for the three months and six months ended June 30, 2002, compared to $1.8 million and $4.4 million, or 18% and 24% of total revenue, for the three months and six months ended June 30, 2001, due to an increase in direct sales in the United Kingdom and our recently established direct sales operations in France, Germany and Spain.

Table of Contents

Revenue from Canada, South and Latin America and Asia (excluding Japan) increased to $2.1 million and $3.8 million, or 12% and 13% of total revenue, for the three months and six months ended June 30, 2002, compared to $1.6 million and $2.4 million, or 15% and 13% of total revenue, for the three months and six months ended June 30, 2001, primarily due to an increase in orders from our distributors in China, Mexico and Brazil.

Gross margin

Gross margin increased to 58.2% and 58.1% for the three months and six months ended June 30, 2002, compared to 48.2% and 44.8% for the three months and six months ended June 30, 2001. The increase in gross margin was primarily due to an increase in the percentage of direct sales compared with distributor sales.

Operating expenses

Research and development expenses were $3.1 million and $6.3 million for the three months and six months ended June 30, 2002, compared to $3.2 million and $6.8 million for the three months and six months ended June 30, 2001. Research and development expenses decreased primarily due to a reduction in product development costs after the completion and introduction of the SonoHeart ELITE during the first quarter of 2002.

Sales and marketing expenses were $7.7 million and $14.0 million for the three months and six months ended June 30, 2002, compared to $5.5 million and $11.1 million for the three months and six months ended June 30, 2001. The increase was primarily due to an increase in direct selling expenses in the United States and Europe associated with the increase in the number of sales representatives and sales management.

General and administrative expenses were $1.4 million and $2.9 million for the three months and six months ended June 30, 2002, compared to $1.0 million and $2.1 million for the three months and six months ended June 30, 2001. The increase in general and administrative expenses is related primarily to supporting our business growth and to legal expenses incurred to defend our intellectual property rights. We expect to incur additional legal expenses as we continue to defend our patent rights in the patent litigation described below in Part II, Item1, Legal Proceedings, although the timing and amount of such expenses are unknown.

Other income (loss)

For other income and loss, we reported income of $88,000 and $38,000 for the three months and six months ended June 30, 2002, compared to losses of $280,000 and $86,000 for the three months and six months ended June 30, 2001. The increase was primarily due to a loss on investments of $290,000 recorded in the second quarter of 2001. We expect the losses of affiliates to decrease due to a winding down of our joint venture in China as we transition to a dealer network.

Liquidity and Capital Resources

Our cash and cash equivalents balance was $71.7 million as of June 30, 2002, compared to $33.1 million as of December 31, 2001. The increase in cash and cash equivalents resulted from the sale of 2,700,000 shares of our common stock at $17.25 per share in May 2002. Cash and cash equivalents were primarily invested in money market accounts.

Operating activities used cash of $3.1 million for the six months ended June 30, 2002 compared to $11.6 million for the six months ended June 30, 2001. The decrease in cash used in 2002 compared with 2001 was primarily due to a reduction in our net loss.

Investing activities used cash of $1.3 million for the six months ended June 30, 2002, compared to cash provided of $9.3 million for the six months ended June 30, 2001. The cash used in 2002 was primarily due to purchases of property and equipment. The cash provided in 2001 was primarily due to maturities of investment securities and was partially offset by the purchases of investment securities and property and equipment.

We anticipate using cash to invest in high quality investment instruments in 2002, the extent of which will be dependent upon the interest rate environment during the year and the timing of cash flows from our operations during the year.

Financing activities provided cash of $42.9 million for the six months ended June 30, 2002, compared to $331,000 for the six months ended June 30, 2001. The cash provided in 2002 was primarily due to the sale of 2,700,000 shares of our common stock at $17.25 per share in May 2002.

We anticipate that cash used in operations will decrease in 2002 compared to 2001 primarily due to anticipated decreases in our net loss. This decrease will be dependent upon our ability to successfully sell our products, collect our receivables, control our inventories and manage our expenses.

We believe that our existing cash and cash generated from operations will be sufficient to fund our operations and capital expenditure requirements for at least the next year. Nevertheless, we may experience an increased need for additional cash due to:

- any adverse impact to our revenues or gross margins as a result of increased competition;
- any delay or inability to collect accounts receivable timely as a result of continued or deteriorating global economic conditions;
- a need to significantly increase our sales and marketing and research and development expenditures as a result of increased competition or new market opportunities; and
- a need to significantly increase our sales and marketing expenditures as a result of our introduction of new products.

Important Factors That May Affect Our Business, Our Results of Operations and Our Stock Price

If our products do not gain market acceptance, we will fail to generate sufficient revenue to maintain our business.

The market for hand-carried, high performance ultrasound devices is new and largely undeveloped. Our products represent a new technological alternative to traditional ultrasound examinations. We seek to sell our products to current users of ultrasound, as well as to physicians and other healthcare providers who do not currently use ultrasound, and our success will depend on the acceptance of our products by the medical community, patients and third-party payors as medically useful, safe and cost-effective. Competing hand-carried or traditional cart-based ultrasound devices may be more cost-effective than our products. Physicians and other healthcare providers may adopt our products at a slow rate, if at all. If the market fails to accept our products, we will be unable to generate sufficient revenue to maintain our business.

If we are unable to compete effectively, we will fail to generate sufficient revenue to maintain our business.

We currently face competition from companies that manufacture cart-based and portable ultrasound devices. The dominant competitors in this industry are GE Medical Systems, a unit of General Electric Company, Siemens AG and Philips Medical Systems, a unit of Koninklijke Philips Electronics, N.V. that recently purchased two other competitors, Agilent Healthcare Solutions Group and ATL, our former parent company. These competitors are very large, global organizations and have the following advantages over us:

- 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 potential customers.

These manufacturers of cart-based and portable ultrasound devices could use their greater resources to increase and withstand competition through various means, including price and payment terms, product quality, market penetration, employee compensation, hospital systems integration and complementary services such as warranty protection, maintenance and product training. Existing product supply relationships between these companies and our potential customers could discourage widespread adoption of our products due to brand loyalty or preferred customer discounts. Competition from these companies could result in higher turnover of our employees. If we are unable to respond to competitive pressures from the cart-based and portable ultrasound markets, we could experience delayed or reduced market acceptance of our products, higher expenses and lower revenue.

In addition, as the market for hand-carried, high performance ultrasound devices develops, we expect competition to increase as potential and existing competitors enter the hand-carried market or modify their existing products to more closely approximate the combined portability, quality, performance and cost or our products. Our current competitors in the hand-carried market include GE Medical Systems, Agilent/Philips Medical Systems, Biosound Esaote, Inc., Medison America Inc., a subsidiary of Medison Company, Ltd., and Terason, a division of TeraTech Corporation. Other potential entrants to the hand-carried market include Novasonics, Inc. These competitors may develop highly portable or hand-carried ultrasound devices that offer the same or greater reliability and quality, perform greater or more useful functions, or are more cost-effective than our products. If we are unable to compete effectively with new entrants to the hand-carried, high performance ultrasound market, we will be unable to generate sufficient revenue to maintain our business.

13

Table of Contents

If our competitors develop and market medical imaging devices that render our products obsolete or noncompetitive, we will be unable to compete.

The life cycles of our products are difficult to estimate. Our products could become obsolete or unmarketable if:

- our competitors introduce ultrasound devices that are superior to ours;
- other products using new technologies emerge; or
- industry standards exceed our products capabilities.

If we fail to enhance our existing products or develop and market new products, our products will become obsolete and we will be unable to compete.

Our single technological platform renders us less able to withstand adverse changes in the market.

Although we market our products for use in a variety of clinical applications and settings, we have only a single technological platform upon which all our ultrasound devices are based. Any attempt to design a new platform for ultrasound imaging will require substantial amounts of time and money, and may not be successful. If our platform becomes obsolete, unmarketable or unaccepted by the market for any reason, and we are unable or slow to develop a new platform to replace it, we will be unable to generate sufficient revenue to maintain our business.

If traditional providers of ultrasound examinations discourage potential new users from adopting our products, we could experience limited demand for our products.

In traditional ultrasound practice, physicians and other healthcare providers typically refer patients to centralized locations where radiologists and other specialized personnel provide ultrasound examinations. Although our products are currently used by radiologists, our products also enable the delivery of ultrasound examinations at the primary point of care by the examining physician or healthcare provider. Radiologists and other ultrasound specialists have a professional and financial interest in maintaining traditional ultrasound practice. If these traditional providers of ultrasound examinations discourage other healthcare providers from adopting our products, we could experience limited demand for our products.

If the training and education necessary to conduct ultrasound examinations discourage new users from adopting our products, we could experience limited demand for our products.

We seek to sell our products to customers already experienced in ultrasound procedures, as well as to physicians and other healthcare providers who do not currently use ultrasound imaging devices or administer ultrasound examinations. Although customers who are experienced in ultrasound procedures will need little, if any, specialized training to use our products, any new users of ultrasound will require training and education to properly administer ultrasound examinations. If these potential customers are unable or unwilling to be trained due to cost, time constraints, unavailability of courses or other reasons, we could experience limited demand for our products.

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

We depend on suppliers, including some single-source suppliers, to provide highly specialized parts, such as custom-designed integrated circuits, cable assemblies and transducer components. We also depend on single-source suppliers to provide other components, such as image displays, batteries, capacitors and cables. We do not maintain significant inventories of components, and may experience an interruption of supply if a supplier is unable or unwilling to meet our time, quantity and quality requirements. There are relatively few alternative sources of supply for some of these components. An increase in demand for some parts by other companies could also interrupt our supply of components. We have in the past experienced supply problems in timeliness and quality, but to date these problems have not resulted in lost sales or lower demand. Nevertheless, if we experience an interruption of supply or are required to switch suppliers, the manufacture and delivery of our products could be interrupted, our manufacturing costs could substantially increase and we could lose substantial amounts of product sales.

Table of Contents

If we or our suppliers fail to comply with regulations governing our manufacturing practices, we could experience production delays, cost increases and lost sales.

The FDA requires us and our key medical device suppliers to demonstrate and maintain compliance with the FDA s Quality System Regulation, or QSR, which covers the methods and documentation of the design, testing, production, control, quality assurance, labeling, packaging, shipping and servicing of our products. The FDA enforces the QSR through periodic inspections. We, or any of our key medical device suppliers, may fail to comply with regulatory requirements. Failure to take corrective action in response to a QSR inspection could force a shutdown of our manufacturing operations and a recall of, or field action relating to, our products. Such failure may prevent us from meeting production schedules, minimizing manufacturing costs, maintaining quality requirements or completing product sales.

For example, the FDA inspected our manufacturing facility in August 2001. In addition, the British Standards Institution performed a management systems assessment of our manufacturing processes in May 2000, February 2001, June 2001, and November 2001. These inspections resulted in observations to which we submitted responses, and we believe these responses have been accepted by those agencies. Also, in August 2001 the FDA classified as a class II field action a May 2000 software upgrade we issued to correct an error in an algorithm contained in one of our products. If our appeal of this classification is unsuccessful, we will be required to take additional steps in an effort to ensure that all affected purchasers receive the upgrade. If required to take action, we do not believe the associated costs will be significant. 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.

Our limited manufacturing experience and the complexity of our products may impair our ability to respond effectively to manufacturing problems, manage our inventory and avoid excessive warranty costs.

Prior to the fourth quarter of 2000, we had outsourced the manufacture of our products to ATL. In the fourth quarter of 2000, we transitioned product manufacturing to our own facility under the control of our employees. In order to make this transition, we built a series of manufacturing lines and developed our own manufacturing processes and procedures. We have limited experience in managing manufacturing problems and risks, such as line shutdowns, product procurement issues, regulatory compliance, rework, quality system issues or yield issues. We manufacture our products and determine product mix based on forecasts of sales in future periods. Incorrect forecasts and long order lead-times could lead to shortages or surpluses of product inventory. If we experience any manufacturing problems, we may experience delays in shipping our products. Our failure to effectively manage our manufacturing process may prevent us from meeting production schedules, minimizing manufacturing costs, maintaining quality requirements or completing product sales.

In addition, our products are intricate and technically complex. As a result, deficiencies in our design and manufacturing process may result in significant warranty exposure. Our products generally carry a one-year warranty against defects in materials and workmanship. We will be responsible for all claims, actions, damages, liens, liabilities and costs for all product field actions, returns and defects attributable to manufacturing. Although we have established accruals for the liability associated with product warranties, any unforeseen warranty exposure could increase our expenses and impair our operating results.

Our reliance on a single manufacturing facility may impair our ability to respond to natural disasters or other unforeseen catastrophic events.

Our sole manufacturing facility is located in a single building in Bothell, Washington. Despite precautions taken by us, a natural disaster such as an earthquake or other unanticipated catastrophic events at this building could significantly impair our ability to manufacture our products and operate our business. Our facility 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. While we carry insurance for natural disasters and business interruption, the occurrence of such event could result in losses that exceed the amount of our insurance coverage, which would impair our financial results.

If our products do not perform as expected, we could experience lost revenue, delayed or reduced market acceptance of our products, increased costs and damage to our reputation.

Our success depends on the market s confidence that we can provide reliable, high quality medical devices. Our customers are particularly sensitive to product defects and errors because of the use of our products in medical practice. Our reputation and the public image of our products may be impaired for any of the following reasons:

- failure of products to perform as expected;
- a perception that our products are difficult to use; and
- litigation concerning the performance of our products or our technology.

Even after any underlying problems are resolved, any manufacturing defects or performance errors in our products could result in lost revenue, delay in market acceptance, damage to our reputation, increased service and warranty costs and claims against us.

We have a history of losses, we expect future losses and we may never be profitable.

We have incurred net losses in each quarter since we commenced operations. As of June 30, 2002, we had an accumulated deficit of approximately $84.1 million. Although we will continue to incur additional losses in the near term, we expect to achieve one or more profitable quarters within the next several quarters. Even if we do achieve one or more profitable quarters, however, we may be unable to sustain or increase future profitability on a quarterly or annual basis. Additionally, our losses may increase if we cannot increase or sustain our revenue. Our revenue from product sales has been insufficient to cover our expenses, and we expect that our operating expenses will substantially increase in the foreseeable future as we expand our sales and marketing infrastructure, our manufacturing capability and possibly our product development activities. Our expansion efforts, to be successful, may require more funding than we currently anticipate. Accordingly, we will need to generate significant additional revenue in the future before we will be able to sustain or increase profitability. If we cannot generate such revenue, we may never be profitable. If we fail to achieve or sustain profitability, the market price for our common stock will likely fall.

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

We have experienced rapid growth since our inception as a stand-alone company. Our revenue increased from $10.2 million in 1999 to $32.0 million in 2000 and $45.7 million in 2001. During 2001, we increased the number of our sales representatives in the United States from 26 to 51, introduced two new products to the market and began expanding our operations in Europe. During the first half of 2002, we introduced two new products and continued our expansion into Europe. On June 20, 2002, we announced that we had received 510(k) clearance from the FDA for our new iLook platform. We expect to commence sales efforts of the iLook late in the third quarter of 2002. We expect continued significant growth in all areas of operations as we continue to develop, manufacture, market and sell our products. Our growth could strain our existing management, operational and financial resources. In order to manage our growth effectively, we will need to expand our manufacturing and quality assurance staff, our sales staff and our manufacturing capabilities. In addition, we will need to improve the productivity and efficiency of our existing operational, financial and management resources 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. If we fail to timely improve or augment our existing resources in response to our growth, we may be unable to effectively manage our business and achieve our objectives.

Our strategy of expanding and maintaining our domestic sales force may fail to generate a substantial increase in sales.

We began direct sales of our products in the United States in February 2000 with a sales force comprised of sonographers with little direct sales experience. Since then, we have nearly doubled the size of our direct sales force in the United States by supplementing our sonographers with trained professional sales people. We have also added, and may continue to add, clinical application specialists, including cardiology product specialists, in an effort to improve our sales efficiency and reach new markets. This expansion has required, and will continue to require, extensive training efforts, substantial management attention and a substantial increase in sales and marketing expenses. Despite our expenditures and efforts, we may not successfully expand our market penetration or generate a substantial increase in sales.

Our limited financial resources may impair our ability to market our products effectively and may limit our product sales.

Marketing is critical to generate awareness of our products and promote the new uses of ultrasound that our products enable. Our marketing efforts must overcome the marketing efforts of our competitors, as well as the resistance that may be shown by both existing and new ultrasound users. We have incurred and will continue to incur significant expenditures for a range of marketing efforts, including attendance at trade shows, direct mail solicitations and print advertising. If our limited financial resources impair our marketing budget, we may be unable to generate sufficient brand awareness to positively impact product sales. This lack of brand awareness may result in delayed or reduced market acceptance of our products and may limit our product sales.

If our operating results fluctuate and fall below expectations of securities analysts and investors, our stock price may decline and you may lose some or all of your investment.

Our operating results have fluctuated in the past, and we expect these fluctuations to continue in the foreseeable future. Many factors affecting our quarterly operating results are outside our control, including:

- product and price competition;
- global economic conditions;

- performance of our third-party distributors;
- year-end customer budget constraints and other customer buying patterns; and
- changes in component cost and availability.

Other factors are difficult to control, including:

- demand for our products;
- estimating appropriate manufacturing levels for forecasted sales;
- inventory management and obsolescence;
- performance of our direct sales and distribution channels;
- development of new and enhanced products;
- product introductions and commercializations; and
- timing and magnitude of our expenses.

A negative fluctuation of our operating results could run contrary to the expectations of securities analysts or investors, which may reduce the market price of our stock and cause a loss of some or all of your investment.

Our creation, maintenance and expansion of direct sales and distribution operations in Europe will burden our resources and may fail to generate a substantial increase in sales.

We have historically relied on third-party distributors to sell our products in Europe. We recently commenced operations in the United Kingdom, France, Germany and Spain to sell our products directly in each of those countries. We expect to expand our European direct sales operations in the future. Establishing, maintaining and expanding these operations will require us to:

- substantially increase our costs of operations;
- temporarily divert existing management resources;
- establish an efficient and self-reliant local infrastructure;
- attract, hire and train qualified local sales and administrative personnel;
- comply with additional local regulatory requirements; and
- expand our information, financial, distribution and control systems to manage expanded global operations.

Our movement into Europe has required, and will continue to require, substantial financial and management resources. The costs of this expansion are unpredictable, difficult to control and may exceed budgeted amounts. Despite our expenditures and efforts, we may not generate a substantial increase in European revenue, which would impair our operating results.

Our foreign revenue is subject to currency fluctuation and other risks associated with doing business outside the United States.

The percentage of our revenue originating outside the United States equaled 50% in 2001 and 43% in the six months ended June 30, 2002. Of this foreign revenue, approximately 26% originated in Japan in 2001 and 24% in the six months ended June 30, 2002. Our revenue from international sales may be adversely affected by any of the following risks:

- currency rate fluctuations;
- political and/or economic conditions;

- reduced protection for intellectual property rights;
- longer receivables collection periods and greater difficulty in receivables collection;
- localizing products for foreign markets; and
- compliance with export laws, including license requirements, trade restrictions and tariff increases.

As of June 30, 2002, 50% of our outstanding accounts receivable balance was from international customers. Our distributor in Japan was indebted to us for approximately $1.8 million, representing 12% of our outstanding accounts receivable balance. In addition, approximately 4% of our outstanding receivables was from a single customer in Argentina who was indebted to us for $582,000. We regularly review our receivable position in foreign countries for any indication that collection may be at risk. For example, due to recent economic events in Argentina, including the decision to allow the Argentine peso to float against the U.S. dollar, we recorded an allowance of $407,000 on an account in Argentina and we may be required to write off some or all of our Argentine receivables.

Our foreign distributors may be unwilling or unable to devote sufficient resources to market and sell our products, which could delay or reduce market acceptance and sales of our products outside the United States.

We currently depend on foreign distributors to help promote market acceptance and demand for our products in countries in which we do not have a direct sales force. For example, sales to our distributor in Japan, Olympus, represented 17% of our revenue in 2001 and 10% of our revenue in the six months ended June 30, 2002. Foreign distributors that are in the business of distributing other medical products may not devote the resources and support required within these countries to generate awareness of our products and grow or maintain product sales. If these distributors are unwilling or unable to market and sell our products, we could experience delayed or reduced market acceptance and sales of our products outside the United States.

The loss of any principal member of our management team or scientific staff, on whom we rely heavily, could impair our ability to compete.

Our success depends heavily on our ability to retain the services of the principal members of our management team and scientific staff. 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. The loss of any of our key employees could significantly delay or prevent the achievement of our scientific or business objectives.

On July 30, 2002, we announced that Jens U. Quistgaard, Ph.D., SonoSite s chief product and strategy officer, would leave SonoSite to become the president and chief executive officer of LipoSonix, Inc., a private company based in the Seattle area. LipoSonix is developing medical devices for cosmetic surgery applications and is not a SonoSite competitor. Dr. Quistgaard s departure became effective on August 5, 2002.

If we are unable to protect and enforce our intellectual property rights, we may be unable to compete effectively.

Much of our value arises out of our proprietary technology and intellectual property for the design, manufacture and use of hand-carried ultrasound imaging devices. Our success and ability to compete effectively depend on our ability to protect our proprietary information. 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.

We currently hold five patents relating to the weight of digital beamformers, beamforming capabilities, digital conversion circuitry, transceiver circuitry and circuit integration. Additionally, we have a license from our former parent, ATL, to use certain ATL technology and ATL technological developments in our hand-carried products. This license is exclusive through April 5, 2003, and nonexclusive after that date. We also enter into confidentiality or license agreements with our employees, consultants and corporate partners, and generally control access to, and the distribution of, our product designs, documentation and other proprietary information, as well as the designs, documentation and other information that we license from others.

Our efforts afford only limited protection and may not adequately protect our rights to the extent necessary to sustain any competitive advantage we may have. Despite our efforts to protect our intellectual property, we may experience:

- unauthorized use of our technology by competitors;
- independent development of the same or similar technology by a competitor, coupled with a lack of enforceable patents on our part;

18

- failure of our pending patent applications to result in issued patents;
- successful interference actions to our patents or successful oppositions to our patents and patent applications;
- unauthorized disclosure or use of our proprietary information by former employees or affiliates; and
- failure by our commercial partners to comply with their obligations to share technology or use our technology in a limited manner.

Policing unauthorized use of our intellectual property will be difficult and may be cost-prohibitive. 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 devices, which could decrease our market share.

If we are involved in intellectual property claims and litigation, the proceedings 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. In addition, others may initiate patent litigation against us. 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 medical device field. The validity and breadth of medical technology patents may involve complex legal and factual questions for which important legal principles may remain unresolved. In addition, because patent applications can take many years to result in issued patents and are maintained in confidence by the U.S. Patent and Trademark Office while pending, there may be currently pending applications of which we are unaware, which may later result in issued patents that our products may infringe. There could also be existing patents of which we are not aware that one or more of our products may infringe. Litigation may be necessary to:

- assert or defend against claims of infringement;
- enforce our issued and licensed patents;
- protect our trade secrets or know-how; or
- determine the enforceability, scope and validity of the proprietary rights of others.

We may become involved in the defense and prosecution, if necessary, of intellectual property suits, patent interferences, opposition proceedings and other administrative proceedings. For example, on July 24, 2001, Neutrino Development Corporation filed a complaint against us, which alleged that our sale and manufacture of our hand-carried ultrasound devices infringed upon a patent held by Neutrino. We responded to the claim, asserting alternative defenses of noninfringement and patent invalidity. In addition, we filed a counterclaim seeking a declaratory judgment of noninfringement and invalidity regarding Neutrino s patent. We also defeated Neutrino s request for a preliminary injunction preventing us from manufacturing and selling our products for the duration of the litigation. On February 20, 2002, in what is known as a Markman hearing, the parties presented their arguments regarding the proper construction of Neutrino s patent claims. The court has not yet ruled on the issues presented in that hearing, and may issue a ruling at any time. Although we continue to vigorously defend ourselves against this claim, this litigation may result in an adverse judgment against us. Sales of the allegedly infringing products represented virtually all of our revenue for the six months ended June 30, 2002 and the years ended December 31, 2001, 2000 and 1999. Through June 30, 2002, we had incurred approximately $1.2 million in defense of this claim, and we expect to incur additional substantial litigation expenses until the claim is resolved.

Our involvement in intellectual property claims and litigation could:

- divert existing management, scientific and financial resources;
- subject us to significant liabilities;
- allow our competitors to market competitive products without obtaining a license from us;
- cause product shipment delays and lost sales;

require us to enter into royalty or licensing agreements, which may not be available on terms acceptable to us, if at all; or

force us to discontinue selling or modify our products, or to develop new products.

The termination or other loss of our license to use certain ATL technology would significantly impair our ability to manufacture, market and sell our products.

We license certain technology from ATL that is incorporated into our single technology platform, and we use this ATL technology in all of our hand-carried ultrasound imaging devices. Virtually all 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. Although many key aspects of our technology platform including the high level of miniaturization that allows us to manufacture high performance, hand-carried, all-digital ultrasound imaging devices are independently owned by us under the terms of our spin-off from ATL, 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 happens, we may be unable to generate sufficient revenue to maintain our business.

If healthcare reimbursement practices or reform restricts coverage available to our customers for the use of our products, we may experience limited market acceptance of our products.

Market acceptance of our products depends in part on the extent to which our customers will receive reimbursement for the use of our products from governmental authorities, private health insurers and other third-party payors. Our customers currently receive reimbursement for ultrasound procedures performed using our products consistent with reimbursement criteria applicable to ultrasound procedures generally. The continuing efforts of governmental authorities, private health insurers and other third-party payors to contain or reduce the costs of healthcare through various means may, however, limit market acceptance of our products. Increasing efforts by governmental and third-party payors, such as Medicare, private insurance plans and managed care organizations, to contain or reduce healthcare costs may affect our ability to market our current products, commercialize our potential products and become profitable. Reimbursement coverage, to the extent available, may not be adequate to enable us to achieve market acceptance of our products. In addition, we believe that third-party payors will attempt to reduce healthcare costs by limiting both coverage and level of reimbursement for new products cleared by the FDA or comparable foreign agencies. Our products enable new kinds of medical procedures involving novel ultrasound applications for which there is no reimbursement history. The efforts of government and third-party payors to contain or reduce the cost of healthcare could restrict physicians and other healthcare providers willingness to select our products and implement new ultrasound procedures, which could delay or reduce market acceptance of our products.

Additionally, there has been and will continue to be a number of federal and state proposals to implement government controls on pricing. The existence and adoption of these proposals could affect our ability to successfully market our current products and commercialize new products.

Compliance with governmental regulation of our business could be costly and time-consuming, and could prevent us from introducing new products in a timely manner.

Our products, our manufacturing 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. Our third-party manufacturers and we are or will 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.

Compliance with the regulations of these 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. We may be subject to fines, sanctions, including the temporary or permanent suspension of operations, product field actions, criminal prosecution and marketing restrictions, if we fail to comply with the laws and regulations pertaining to our business. Our third-party medical device manufacturers may also be subject to the same sanctions and, as a result, may fail to supply us with components required to manufacture our products.

Table of Contents

Product liability and other claims and product field actions could increase our costs, delay or reduce our sales and damage our reputation, which could significantly impair 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 damage our reputation by raising questions about our products safety and efficacy, and could interfere with our efforts to market our products. Although to date we have not been involved in any medical malpractice or product liability litigation, we may incur significant liability if such litigation were to occur. We may also face adverse publicity resulting from product field actions or regulatory proceedings brought against us. Although we currently maintain liability insurance in amounts we believe are commercially reasonable, any product liability we incur may exceed our insurance coverage. Liability insurance is expensive and may cease to be available on acceptable terms, if at all. A product liability or other claim or product field action not covered by our insurance or exceeding our coverage could significantly impair our financial condition. In addition, a product field action or a liability claim against us could significantly harm our reputation and make it more difficult to obtain the funding and commercial relationships necessary to maintain our business.

If our stock price continues to be volatile, your shares may decline in value.

The market price for our common stock, as well as for securities of emerging growth companies generally, has been volatile in the past and is likely to continue to be volatile. You may be unable to resell your shares at or above the price you paid due to a number of factors, many of which are beyond our control, including:

- the difference between quarterly operating results and those expected by investors or securities analysts;
- changes in earnings estimates by analysts;
- the loss of significant orders;
- announcements of technological innovations or new products by our competitors;
- changes in the structure of healthcare financing and payment systems;
- general conditions in the medical industry or global economy;
- a lack of liquidity in the market for our stock; and
- significant sales of our common stock by one or more of our shareholders.

Our future capital-raising activities could involve the issuance of equity securities, which would dilute your investment and could result in a decline in the trading price of our common stock.

To meet our long-term funding requirements, we may sell securities in the public or private equity markets if and when conditions are favorable, even if we do not have an immediate need for additional capital at that time. For example, in May 2002, we raised net proceeds of $42.6 million through the sale of 2,700,000 shares of our common stock. Furthermore, we may enter into financing transactions at prices that represent a substantial discount to market price. Raising funds through the issuance of equity securities will dilute the ownership of our existing shareholders. A negative reaction by investors and securities analysts to any sale of our equity securities could result in a decline in the trading price of our common stock.

If we incur 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. If ATL were to recognize 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

Table of Contents

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.

If our expenses exceed our revenue and we fail to obtain timely additional financing, we could experience delays or reductions in our product development and sales efforts, which would impair our operating results.

To date, our revenue has been insufficient to cover the expenses of our operations. Our future revenue may continue to be insufficient to support the expenses of our operations and the expansion of our business. We may therefore need additional equity or debt capital to finance our operations as we develop our products and expand our sales. To date, our capital requirements have been met primarily by the sale of equity, revenue and contributions by ATL in connection with our spin-off. Specifically, in May 2002, we raised net proceeds of $42.6 million through the sale of 2,700,000 shares of our common stock, in August 2001, we raised net proceeds of $23.1 million through the sale of 1,666,667 shares of our common stock, in November 1999, we raised net proceeds of $29.3 million through the sale of 1,250,000 shares of our common stock and in April 1999, we raised net proceeds of $35.4 million through the sale of 2,990,000 shares of our common stock. In connection with the spin-off, we received $30 million in contributed capital from ATL. ATL has no further obligations to provide us with funding, and we do not expect any future funding from this source. Therefore, if we require additional financing, we would need to explore other sources of financing, including public equity or debt offerings, private placements of equity or debt and collaborative or other arrangements with corporate partners. Financing may be unavailable when needed or may be unavailable on acceptable terms. If we fail to obtain financing, we may be required to delay, reduce or eliminate some or all of our research and development and sales and marketing efforts, and our business could fail.

The concentrated ownership of our common stock could delay or prevent a change of control, which could cause a decline in the market price of our common stock.

As of December 31, 2001, our executive officers, directors and affiliated entities together beneficially owned approximately 5% of the outstanding shares of our common stock. Four other shareholders owned in the aggregate approximately 42% of the outstanding shares of our common stock. Among these shareholders, the State of Wisconsin Investment Board, or SWIB, owned approximately 17.2% of the outstanding shares of our common stock and WM Advisors owned approximately 11.6%. As a result, these shareholders or any other concentrated owner may be able to exert significant influence over all matters requiring shareholder approval, including the election of directors, matters relating to the attraction and retention of employees, and approval of significant corporate transactions that could include certain matters relating to future financing arrangements and unsolicited tender offers. This concentration of ownership may delay, deter or prevent a third party from acquiring control over us at a premium over the then-current market price of our common stock, which could result in a decline in our stock price.

Our restated articles of incorporation, our bylaws, Washington law and some of our agreements contain provisions that could discourage a takeover and prevent shareholders from receiving a premium for their shares.

There are provisions in our restated articles of incorporation, our bylaws and Washington law that make it more difficult for a third party to obtain control of us, even if doing so would be beneficial to our shareholders.

Additionally, our acquisition may be made more difficult or expensive by the following:

- change of control provisions in our license agreement with ATL, which require us to pay ATL:
  - $150 million if, prior to April 6, 2003, any single person or entity obtains, directly or indirectly, voting control of a majority of our common stock or the power to elect our entire board of directors; or
  - $75 million if, at any time between April 6, 2003 and April 6, 2006, any single person or entity engaged in the medical diagnostic imaging business, other than through the sale or manufacture of our products, obtains, directly or indirectly, voting control of a majority of our common stock or the power to elect our entire board of directors;
- acceleration provisions in benefit plans and change-in-control agreements with our employees; and

our shareholder rights plan, which is designed to dilute a hostile acquiror s interest so that the acquisition becomes prohibitively expensive. Under our rights plan, each of our shareholders has one share purchase right for each share of common stock held, with each right having an exercise price approximating our board of directors estimate of the long-term value of one share of our common stock. The rights are triggered if an acquiror acquires, or successfully makes a tender offer for, 15% or more of our outstanding common stock. In such event, each shareholder other than the acquiror would have the right to purchase, at the exercise price, a number of newly issued shares of our capital stock at a 50% discount. If the acquiror were to acquire 50% or more of our assets or earning power, each shareholder would have the right to purchase, at the exercise price, a number of shares of acquiror s stock at a 50% discount. Our board of directors may redeem the rights at a nominal cost at any time before a person acquires 15% or more of our outstanding common stock, which allows board-approved transactions to proceed. In addition, our board of directors may exchange all or part of the rights (other than rights held by the acquiror) for such number of shares of our common stock equal in value to the exercise price. Such an exchange produces the desired dilution without actually requiring our shareholders to purchase shares. Our rights plan excludes SWIB s ownership of our common stock so long as such ownership does not reach 20% of our outstanding common stock.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest rate risk

Our exposure to market risk, as it relates to changes in interest rates, is not considered to be significant due to the short-term nature of our investments currently. Nearly all funds are held in money market accounts. If we were to invest these funds, our investment policy requires us to invest in high quality, short-term instruments with companies rated A or better by Moody s or Standard and Poor s or commercial paper rated A-1 or P-1 or better.

As of June 30, 2002, we held $71.7 million in cash and cash equivalents and had no investments in debt securities. As of December 31, 2001, we held $33.1 million in cash and cash equivalents and had no investments in debt securities.

Foreign currency risk

Except for sales transacted by our wholly owned subsidiaries, we transact all our sales in U.S. dollars, or USDs; therefore, the obligations of our international customers are in USDs. Our exposure to risk from fluctuations in foreign currencies relates primarily to the strengthening of the USD against the local currency of our international customers, which may impact our ability to collect amounts owed by our international customers.

As of June 30, 2002, 50% of our outstanding accounts receivable balance was from international customers, of which 20%, or approximately $1.5 million, was denominated in a currency other than USDs. Total revenue for the six months ended June 30, 2002 denominated in a currency other than USDs were approximately $3.7 million. The British pound represented the majority of financial transactions executed in a currency not denominated in USDs. A change in exchange rates compared to the USD of 10% would not have a significant impact on our statement of financial position or results of operations. Historically, the impact on us of changes in the exchange rates compared to the USD has been insignificant. We regularly review our receivable position in foreign countries for any indication that collection may be at risk. A single customer in Argentina was indebted to us for $582,000 at June 30, 2002, for which an allowance of $407,000 was recorded as a result of economic conditions in Argentina. In addition, we utilize letters of credit where they are warranted in order to mitigate our collection risk.

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

On July 24, 2001, Neutrino Development Corporation filed a complaint against us in U.S. District Court, Southern District of Texas, Houston Division, alleging infringement of U.S. Patent 6,221,021 by SonoSite as a result of our use, sale and manufacture of the SonoSite 180, SonoSite 180 PLUS, SonoHeart and SonoHeart PLUS devices. The complaint asserts claims for preliminary and permanent injunctive relief enjoining all alleged acts of infringement, compensatory and enhanced damages, attorney s fees and costs, and pre- and post-judgment interest. On August 14, 2001, we filed an answer asserting alternative defenses of non-infringement and patent invalidity, and including a counterclaim seeking a declaratory judgment of non-infringement and invalidity regarding Neutrino s patent. On October 4, 2001, the court denied a request by Neutrino for preliminary injunctive relief to prevent us from manufacturing and selling our products pending the ultimate disposition of the litigation. On February 20, 2002, in what is known as a Markman hearing, the parties presented their arguments regarding the proper construction of Neutrino s patent claims. The court has not yet ruled on the issues presented in that hearing. We believe we have good and sufficient defenses to the claims of patent infringement asserted against us by Neutrino and we are vigorously defending ourselves in this matter.

Item 4. Submission of Matters to a Vote of Security Holders

On April 30, 2002, we held our annual meeting of shareholders. As of the record date, March 13, 2002, there were 11,374,740 shares of common stock outstanding and entitled to vote at the meeting. Of the shares entitled to vote, 10,176,260 shares, or 89.5%, were represented at the meeting, either in person or by proxy. Election of the board of directors was submitted for vote and the following directors were elected:

	Votes For	Withheld
Kirby L. Kramer	9,859,083	317,177
Kevin M. Goodwin	7,460,006	2,716,254
Edward V. Fritzky	9,860,211	316,049
Steven R. Goldstein, M.D.	5,451,360	4,724,900
Ernest Mario, Ph.D.	9,861,273	314,987
William G. Parzybok, Jr.	9,861,864	314,396
Jeffrey Pfeffer, Ph.D.	9,860,589	315,671
Dennis A. Sarti, M.D.	5,546,943	4,629,317
Richard S. Schneider, Ph.D.	9,860,259	316,001
Jacques Souquet, Ph.D.	5,353,530	4,822,730

In addition, two proposals to amend the SonoSite, Inc. 1998 Stock Option Plan, or 1998 Plan, were submitted for vote and approved by our shareholders. The first proposal to amend the 1998 Plan to add performance goal criteria and to specify the maximum amount for certain awards was approved with 9,787,970 votes in favor, 362,929 votes against and 25,353 abstentions. The second proposal to amend the 1998 Plan to increase by 500,000 the number of shares of common stock issuable under the 1998 Plan for a total issuable number of shares of 2,000,000 was approved with 6,454,050 votes in favor, 3,697,974 votes against and 24,236 abstentions.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit No.	Description
10.1	SonoSite, Inc. 1998 Nonofficer Employee Stock Option Plan, as amended and restated on July 25, 2002
99.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350
99.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350

(b) Reports on Form 8-K

No reports were filed on Form 8-K during the quarter ended June 30, 2002.

Table of Contents

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SONOSITE, INC.
(Registrant)

Dated: August 13, 2002	By:	/s/ MICHAEL J. SCHUH
		Michael J. Schuh **Vice President-Finance, Chief Financial Officer and Secretary (Authorized Officer and Principal Financial Officer)**

25

Table of Contents

INDEX TO EXHIBITS

Exhibit No.	Description
10.1	SonoSite, Inc. 1998 Nonofficer Employee Stock Option Plan, as amended and restated on July 25, 2002
99.1	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350
99.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350

26