SONOSITE INC
Form 10-K
March 16, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

FORM 10-K

x **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended December 31, 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 no. 0-23791

SONOSITE, INC.

(Exact name of registrant as specified in its charter)

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

21919 30th Drive S.E.

Bothell, WA 98021-3904

(425) 951-1200

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

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

None

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

Common stock, $0.01 par value

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

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

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

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

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

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

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

The aggregate market value of the voting stock held by nonaffiliates of the registrant, based on the closing sale price of the registrant s Common Stock on June 30, 2010 as reported on the Nasdaq National Market, was $346,077,099.

As of February 23, 2011, there were 13,609,334 shares of the registrant s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this report, to the extent not set forth herein, is incorporated by reference from the registrant s definitive proxy statement relating to the annual meeting of shareholders to be held in 2010, which definitive proxy statement shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates.

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SONOSITE, INC.

ANNUAL REPORT ON FORM 10-K

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Trademarks

SonoSite, the stylized SonoSite logo, iLook, SonoHeart, SonoMB, LumenVu, TITAN, SonoCalc, MicroMaxx, M-Turbo, and NanoMaxx, are all registered trademarks of SonoSite, Inc. S Series, 180PLUS, 180, S-FAST, S-Nerve, S-ICU, S-Cath, S-MSK, S-GYN, S-Women s Health, ColorHD, and Education Key are trademarks of SonoSite, Inc. CardioDynamics, BioZ Advasense, BioZ Dx, and BioZ are registered trademarks of CardioDynamics International Corporation. VisualSonics and Vevo are registered trademarks of VisualSonics Inc. All other brand names, trademarks or service marks referred to in this report are the property of their owners.

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PART I

Our disclosure and analysis in this report and in our 2010 Annual Report to shareholders, of which this report is a part, contain forward-looking statements. Forward-looking statements provide our current expectations or forecasts of future events. Forward-looking statements in this report include, without limitation:

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

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

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

ITEM 1. BUSINESS

Overview

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

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

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

We design our products for applications where ultrasound has not typically been used such as emergency medicine, surgery, critical care, internal medicine, musculoskeletal, and vascular access procedures as well as for imaging in traditional applications, such as radiology, cardiology, vascular medicine and obstetrics and gynecology (OB/Gyn). In addition, the U.S. military has successfully deployed our systems in traditional hospital settings, field hospitals and forward surgical teams in war zones and areas of conflict. We began shipping our first products in September 1999 and today have an installed base of approximately 62,000 systems worldwide.

Our fourth generation technology platform is the basis of three product lines, the NanoMaxx ultrasound tool, which we introduced in July 2009, the M-Turbo® system and the S Series ultrasound tools, which we introduced in October 2007. These products together with the MicroMaxx® system, our third generation of hand-carried technology and introduced in 2005, offer a broad-based product portfolio for hospital and physician office markets. Based on our proprietary Application Specific Integrated Circuit (ASIC) technology for high-resolution ultrasound imaging, these systems offer image resolution comparable to costly, conventional cart-based ultrasound systems weighing over 200 pounds. A five-year warranty covering the system and SonoSite-manufactured transducers comes standard with these products. In 2009, we introduced a major upgrade for the S Series product line which increased performance and expanded clinical capabilities. Additionally we introduced a specialized configuration of the S Series product for the women s health market.

We commenced operations as a division of ATL Ultrasound, Inc., or ATL (now a part of Philips Medical Systems). On April 6, 1998, we became an independent, publicly owned company. ATL retained no ownership in SonoSite following the spin-off.

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

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.

Medical Ultrasound Imaging

Ultrasound uses low power, high-frequency sound waves to provide noninvasive, real-time images of the body s soft tissue, organs and blood flow. Ultrasound can be cost effective by eliminating the need for more time intensive, invasive and expensive procedures and allowing for earlier diagnosis of diseases and conditions. Further, it does not expose the patient to ionizing radiation that is present in X-ray and computed tomography

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technology. To generate an ultrasound image, a clinician places the transducer on the skin or in a body cavity near or by the targeted area of interest. Tissues and bodily fluids reflect the sound waves emitted by the transducer, which then receives these reflections. Based on these reflections, the ultrasound system s beamformer measures and organizes the sound waves and produces an image for visual examination, using digital or analog signal processing, or a combination of the two. Broadband digital signal processing technology, such as that used by our products, allows an ultrasound system to obtain and process greater amounts of information. Accordingly, digital ultrasound systems produce higher resolution images than analog and hybrid analog/digital ultrasound machines.

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

ICG Technology

The ICG technology we acquired in 2009 makes it possible to measure the heart s mechanical, or blood flow, characteristics. By using our products, physicians have an easy, noninvasive, safe, painless and cost-effective way to monitor the heart s ability to deliver blood to the body.

Our BioZ® products use four BioZ Advasense® ICG sensors (two on the neck and two on the chest) to deliver a high-frequency, low magnitude, alternating current through the chest that is not felt by the patient. Our BioZ Dx ICG Monitor uses proprietary processing methods to measure changes in impedance to the electrical signal, which are then applied to an algorithm to provide cardiac output, the amount of blood pumped by the heart in one minute. Additional parameters that are provided indicate blood flow from the heart, the resistance the heart is pumping against, the force with which the heart is contracting, and the amount of fluid in the chest. These parameters are printed on a report that allows the doctor to customize and optimize treatment for a particular patient.

Ultra High-resolution Imaging

The ultra high-resolution imaging technology that we acquired in 2010 is designed specifically for in vivo imaging of small animals conducted during life sciences research and the pre-clinical stage of the drug development process. The drug development process is broadly divided into three stages: drug discovery, pre-clinical studies and clinical studies. Before a particular drug can be tested on humans, its safety and efficacy must be assessed in the pre-clinical drug development stage. The physics of ultrasound involve trade-offs between image resolution and depth of penetration. Conventional ultrasound systems used in human (or clinical) applications operate in the three to fifteen MHz frequency range, provide spatial resolution down to 300 microns (or 0.3 millimeters), and penetrate to a depth of 80 millimeters. These specifications are sufficient, for example, to image a human fetus. Conversely, when imaging a small animal such as a mouse, much higher resolution is necessary to provide useful images while depth of penetration is not required. Our ultra high-frequency system has a spatial resolution down to 30 microns or 3 centimeters.

Our Markets

According to a report by InMedica, a market research company that focuses on the medical device industry, the worldwide ultrasound market for compact HCU was $810.9 million in 2009, excluding upgrades and services. In the report, InMedica projected that the compact HCU market would grow to $1.3 billion in 2014, representing a compounded annual growth rate of approximately 16.2%. According to the report, compact HCU has benefited from the economic downturn by providing budget minded healthcare providers with cost-effective equipment containing improved image quality and features over more expensive cart-based systems. The

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compact HCU market segment remains the fastest growing sector of the ultrasound market and is being driven by the identification of new clinical applications and expansion into new geographic regions.

Our markets can be classified by location and clinical application. From a location perspective, we see our growth continuing to come from further penetration into the hospital market, the major source of our revenue today. We see strong growth opportunities from sales into the clinic or physician s office, as well as into alternative care sites. On a clinical application basis, we see growth in non-traditional or point-of-care ultrasound markets such as anesthesia and critical care. In the clinic or private practice office setting, we believe that slower growth in the more traditional markets, such as radiology, cardiology and OB/Gyn, will be offset by accelerating growth trends and interest in other physician office settings. We consider the use of HCU in the field medicine applications such as the military and disaster settings as growing opportunities.

Our Strategy

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

Continue to lead the HCU market by building upon and expanding product and technology leadership. We believe our products represent the most advanced and innovative technology available in HCU systems. We are committed to continuing to expand this technological advantage by further enhancing our existing products and creating new ones. As of December 31, 2010, we employed approximately 180 people in research and development. Since our inception in 1998, we have introduced four generations of our hand-carried technology, which have improved performance and expanded clinical capabilities of our systems. The NanoMaxx system, based on our fourth generation ASIC technology platform, incorporates proprietary technology, advanced imaging technologies, including ColorHD to deliver exceptional image quality in a lightweight, rugged form factor. M-Turbo and S Series ultrasound tools, also based on our fourth generation technology, provide scalable technology platforms that will enable us to deliver products to specific clinical applications that vary by size, cost and performance.

Maximize the productivity of our direct sales force. As of December 31, 2010, we employed over 242 direct sales representatives in the U.S., Australia, Canada, France, Germany, India, Italy, Japan, Spain and the United Kingdom. To further enhance the productivity of our direct sales force, we will continue to:

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

Pursue strategic relationships. We are focused on building relationships and gaining access to products and technologies that will enable us to continue to penetrate and develop point-of-care visualization. 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. In 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 point-of-care visualization market in the emergency medical services segment. During 2010, we invested in Carticept Medical Inc.

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(Carticept), a privately held company that develops innovative injection products for the treatment of musculoskeletal injuries. We believe this relationship will expand our access to the market segment for ultrasound-guided injections.

Drive our technology to expand presence into cardiovascular disease management and vascular access. With the acquisition of the BioZ technology, we have entered the market for cardiovascular disease management (CVDM). We will expand our CVDM and vascular access markets by:

- driving ultrasound sales into new markets;
- maximizing sales of impedance cardiography technology;
- expanding our sales force; and
- introducing new CVDM technology.

We believe that the performance, mobility, durability and cost effectiveness of our products are resulting in the creation of new clinical markets for us. We believe that new markets will continue to offer us significant potential for additional growth.

Our Products

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

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

With the acquisition of VisualSonics, our product family now includes the Vevo® 770 and the Vevo 2100 micro-imaging systems. The Vevo high-frequency ultrasound technology enables in vivo, real-time, high resolution (as low as 30 microns) visualization and quantification of small animal anatomical targets, hemodynamics, and therapeutic interventions. The Vevo 2100 system expands the functionality, flexibility and image quality of the Vevo 770 system with MICROSCAN solid-state array transducers. MICROSCAN linear array transducers provide increased frame rates, superb contrast, and a wider field of view enabling detailed quantification and assessment of targets. Additionally, advanced software functionality such as color doppler, contrast imaging with micro-bubbles, strain analysis, multiple imaging and processing modes render the Vevo 2100 system to the be the ideal multi-disciplinary in vivo imaging solution for all preclinical research needs.

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The following is a summary of our product platforms:

NanoMaxx Ultrasound Tool. The NanoMaxx system, first shipped in July 2009 and based on our fourth generation technology platform, weighs 6 pounds. It has 5 transducers and can be configured to support a wide range of examinations and procedures including thoracic assessment for hemothorax, hydrothorax and pneumothorax, vascular access, needle aspirations and injections, as well as abdominal, cardiac, nerve, OB/Gyn, musculoskeletal, small parts and vascular scanning. The NanoMaxx system features a touch screen that responds easily to the tap of a finger, and one button optimization. A 5-year warranty comes standard on the system and most of the transducers.

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

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

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

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

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

We also offer accessories and clinical education programs including:

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

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

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BioZ Impedance Cardiography System. Our acquired BioZ systems use ICG technology and reporting features to provide non-invasive hemodynamic parameters for tracking and evaluating cardiovascular health. The BioZ Dx, BioZ Cardio Profile and BioZ Vaso Profile systems use disposable sensors that transmit a small electrical signal through the patient s thorax to measure changes in the aorta s blood volume and velocity with each heartbeat.

Vevo 770 system. The Vevo 770 systems introduced to the market in 2005, has been widely accepted as the gold standard in the field of in vivo imaging across the globe with more than 600 peer reviewed articles published in respected scientific journals on topics ranging from cardiovascular research to drug development.

Vevo 2100 system. The Vevo 2100 systems introduced in 2008, featuring linear array technology, color doppler, extremely high frame rates, quantification and assessment software tools such as contrast imaging, and strain analysis, is finding increased utility in advanced research related to cardiovascular diseases, drug induced vascular injury, tumor visualization, imaging and quantification and brain flow imaging.

Sales and Marketing

We currently sell our products through sales channels comprised of a direct sales force, independent third-party distributors, and strategic alliances. As of December 31, 2010, we employed over 242 direct sales representatives in the U.S. and in our wholly-owned subsidiaries located in Australia, Canada, France, Germany, India, Italy, Japan, Spain, and the United Kingdom. In addition to our direct sales, we sell products in over 100 countries through a network of independent third-party distributors. In addition, we employ regional sales managers responsible for Africa, Asia, China, Europe, Middle East, and Latin America.

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

We derived 49% of our revenue from domestic sales in 2010 compared to 46% in 2009 and 49% in 2008. We attribute revenue to a foreign country based on the location to which we ship our products. Products sold to the U.S. government but deployed in a foreign country are attributed to domestic revenue. Our quarterly revenue is affected by seasonality from year to year with the fourth quarter having the highest revenue, and first quarter being typically the lowest. Quarterly revenue patterns may be affected somewhat by large government orders or shipment of new product inventory to distributors. We currently have one reporting segment. For information regarding revenues and long-lived assets by geography, refer to Note 14 of our consolidated financial statements.

Patents and Intellectual Property Rights

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

We are committed to developing and protecting our intellectual property and, where appropriate, filing patent applications to protect our technology. We hold 67 U.S. patents relating to various aspects of our products,

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including digital beamformers, beamforming capabilities, transducers, digital conversion circuitry, transceiver circuitry, circuit integration, designs and various product configurations. We hold 78 foreign patents relating to our products, and we currently have 73 patent applications pending in the U.S. and 94 registrations pending abroad. In addition, SonoSite has licensed 10 U.S. patents, 16 foreign patents, 8 U.S. patent applications and 42 registrations pending abroad. Our patents will expire at various times ranging from 3.5 to 16 years. Our patent duration is dependent upon the issuing jurisdiction.

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

We license certain high-frequency ultrasound technology from Sunnybrook & Women s College Health Sciences Centre and Company (Sunnybrook) under a license agreement executed in October 2000 (and amended thereafter). Under that license agreement, we received an exclusive license to certain high-frequency ultrasound-technology for visualization of objects at microscopic resolutions developed as part of a Sunnybrook research program which had been established or was being pursued for that technology. Our exclusive license to the high frequency ultrasound technology included certain patent rights, trade secrets and know-how, along with certain rights of first refusal to improvements in high-frequency ultrasound technology developed by Sunnybrook after the execution of the license agreement. Our exclusive license rights are granted for the longer of 15 years from the effective date of the original license agreement or the expiration of the last to expire patent included in the terms of the license agreement. In consideration for this exclusive license to the Sunnybrook high-frequency ultrasound technology, we have an ongoing obligation to pay royalties to Sunnybrook on high-frequency ultrasound products that incorporate Sunnybrook ultrasound technology and/or intellectual property.

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

In order to protect or enforce our patent rights, we may initiate patent litigation. Additionally, others may initiate patent litigation against us. For a description of any such litigation, see Item 3, Legal Proceedings.

Competition

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

In October 2009, we granted a non-exclusive worldwide license right to our patent for ultrasound systems weighing less than ten pounds (U.S. Patent No. 5,722,412 or the 412 patent) to GE Healthcare as part of a

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patent litigation settlement. This is the first such non-exclusive worldwide license right sold. We may encounter increased competition as a result of this license agreement.

We believe that we are the leading developer of high-resolution, ultrasound-based in vivo micro imaging systems devised specifically for non-invasive small animal research.

While we have no direct competitors within pre-clinical ultrasound, there are indirect competitors. We face indirect competition from the established methods of life science research, including histology. We must convince the researcher to change his or her methods and adopt in vivo imaging and, in particular, the Vevo system. In addition, indirect competition comes from other in vivo pre-clinical imaging modalities. There is a mix of large medical imaging companies and smaller, more focused companies that provide alternative pre-clinical imaging modalities.

Research and Development and Technology

We currently employ approximately 180 people in research and development. In 2010, 2009 and 2008, expenses attributable to research and development for our business totaled $32.5 million, $29.0 million and $28.7 million. We believe our products represent the most advanced and innovative technology in high-performance, HCU systems. We believe our technology gives us a competitive advantage, and we are committed to maintaining this advantage by continuing to enhance our existing products and develop new ones.

Manufacturing

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

Governmental Regulation

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

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

We are subject to regulations in each of the foreign countries in which we sell products. Currently, our products bear a CE Mark, which indicates that our products comply with the requirements of the applicable

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

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

Reimbursement

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

Service and Warranty

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

	Beginning of year	Charged to cost of revenue	Applied to liability	Liability Acquired	End of year
Year ended December 31, 2010	$ 8,432	$ 5,744	$ (3,879)	$ 130	$ 10,427
Year ended December 31, 2009	$ 7,094	$ 3,720	$ (2,683)	$ 301	$ 8,432
Year ended December 31, 2008	$ 4,045	$ 4,773	$ (1,724)	$	$ 7,094

Employees

As of December 31, 2010, we had approximately 878 employees, of which approximately 21% were engaged in product research and development, 21% in manufacturing, 44% in sales and marketing activities and the remaining 14% in administrative capacities, including executive, finance, legal, human resources, regulatory and information services and technology. Of these, approximately 596 are U.S. employees. There has never been a work stoppage and no employees are covered by collective bargaining agreements. We believe our employee relations are good.

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Available Information

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

ITEM 1A. RISK FACTORS.

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

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 past and 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. As of December 31, 2010, we are in the process of integrating VisualSonics into our existing operations.

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. As of December 31, 2009, CDIC was successfully assimilated into our operations.

We may explore 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.

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Any acquisition we do in the future or have done in the past may be costly to integrate 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. If reimbursement policies for physician-performed diagnostic ultrasound become more restrictive, or if heightened requirements for proof of clinical efficacy are imposed, it may adversely affect our sales revenues.

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;

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- greater experience in product manufacturing, marketing and distribution;
- greater brand name recognition; and
- long-standing relationships with many of our existing and potential customers.

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

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

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

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

In October 2009, we resolved all pending patent litigation with GE Healthcare. Under the terms of the settlement, GE Healthcare 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 from GE Healthcare as a result of this settlement and the license granted to GE Healthcare under it.

We may be negatively impacted by guidelines, recommendations and studies published by various organizations that can reduce the use of our products.

Professional societies, practice management groups, private health/science foundations, and organizations involved in healthcare issues may publish guidelines, recommendations or studies to the healthcare and patient communities from time to time. Recommendations of government agencies or these other groups/organizations may relate to such matters as usage, cost-effectiveness and use of related therapies. Organizations like these have in the past made recommendations about our products and those of our competitors. If any of these organizations do make an adverse recommendation, then we will be unable to generate sufficient revenue to maintain our business.

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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 remain unstable or 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; increased prices in components as a result of higher commodities prices; 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

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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 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 or ultra high-frequency 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. Our agreement does not provide for any guaranteed minimum number of circuit boards to either be manufactured or purchased. We provide the manufacturer with our forecasted demand for circuit boards, which forms the basis of our production plan. 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.

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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 62.1% of our U.S. revenues. The multi-year agreements with these entities are complex, and include contractual pricing limitations, and required fees. 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. However if we do not manage these relationship effectively, renew on 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 could be restricted or terminated and our results could be adversely affected. During 2010, we determined that we were not meeting the requirements of certain contractual pricing agreements. A non-recurring charge to revenue of $1.1 million was recorded for the estimated liability.

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 operating subsidiaries located in the following countries: Australia, Canada, France, Germany, India, Italy, Japan, Spain and the United Kingdom. The percentage of our total revenue originating outside the United States equaled 51%, 54% and 51% for the years ended December 31, 2010, 2009 and 2008, 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;

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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 the U.S. Dollar (USD) were $91.3 million or 33.1% of our total consolidated revenue and total expenses denominated in a currency other than USD were $46.2 million or 27.4% of our total consolidated operating expenses for the year ended December 31, 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, we seek to manage the counterparty risk associated with engaging in foreign currency contracts by limiting transactions to counterparties with which we have established banking relationships. In addition, as of December 31, 2010, 66.3% of our accounts receivable balance was from international customers, of which 48.9%, or $26.2 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.

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

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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 year ended December 31, 2010, our revenue increased to $275.4 million from $227.4 million for the year ended December 31, 2009. 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 continue to 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 both our Bothell, Washington factory and at our VisualSonics factory in Toronto, Ontario, Canada, 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 limited manufacturing facilities may expose us to greater risk from natural disasters or other unforeseen catastrophic events.

Our corporate headquarters and manufacturing facilities for clinical products are located in two buildings in Bothell, Washington, in close proximity to each other. The manufacturing facilities for VisualSonics are in a single building in Toronto, Canada. Despite precautions taken by us, a natural disaster such as an earthquake or

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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 at both our Bothell and Toronto 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.

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 Healthcare. 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.

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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, including development of point-of-care high-frequency micro ultrasound technology, and pre-clinical high-frequency micro ultrasound 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 145 U.S and foreign patents relating to our technology. We also license a number of patents from academic institutions, other commercial entities and licensing organizations, including key patents relating to our high-frequency micro ultrasound technology and our LumenVu 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. In addition, the breach of a patent licensing agreement by us may result in termination of a patent license.

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, S Series and 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.

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.

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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 impairment charges to our investment portfolio.

Our cash and cash equivalents made up over 23.9% of our total assets as of December 31, 2010. 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.

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

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

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-

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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.

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

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selling by market participants because the conversion of the notes could be used to satisfy short positions, or anticipated conversion of the notes into shares of our common stock could depress the price of our common stock.

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

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

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

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

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

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

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.

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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.

ITEM 1B. UNRESOLVED SEC STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our principal offices are located in Bothell, Washington, where we lease two buildings totaling approximately 125,000 square feet. These facilities include approximately 78,000 square feet of office space and 47,000 square feet of manufacturing and warehouse space. The leases run through 2014. Additionally, we have property in Ilmenau, Germany that includes 7,173 square feet of office space and smaller office facilities at foreign locations in which we have operations. In 2010, through our acquisition of VisualSonics, we acquired additional office space located Toronto, Canada. The leased building is 22,200 square feet, comprised of 16,507 square feet of office space and 5,693 square feet of manufacturing and warehouse space. This lease is scheduled to terminate in 2014.

ITEM 3. LEGAL PROCEEDINGS

None

ITEM 4. RESERVED

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PART II

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

Market Information

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

Year	High	Low
2010		
Fourth quarter	$ 34.90	$ 29.45
Third quarter	$ 34.25	$ 27.80
Second quarter	$ 34.00	$ 25.65
First quarter	$ 32.71	$ 23.61
2009		
Fourth quarter	$ 29.16	$ 21.89
Third quarter	$ 28.48	$ 18.00
Second quarter	$ 20.80	$ 15.27
First quarter	$ 20.58	$ 15.61

Dividends

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

Equity Compensation Plan Information

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

Issuer Purchases of Equity Securities

There were no shares repurchased by SonoSite during the fourth quarter of 2010.

Sales of Unregistered Securities

There were no sales of unregistered securities by SonoSite in 2010.

Holders

As of February 23, 2011, there were 9,872 holders of record of our common stock. This figure does not include the number of shareholders whose shares are held of record by a broker or clearing agency, but does include each such brokerage house or clearing agency as a single holder of record.

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Performance Graph

The following performance graph compares the performance of SonoSite s common stock during the five-year period from December 31, 2006 through December 31, 2010 with the performance of the Nasdaq National Market, U.S. Index and the Nasdaq Medical Devices, Instruments and Supplies, Manufacturers Stocks Index. The graph plots the changes in value of an initial $100 investment over the indicated time periods, assuming all dividends are reinvested. Stock prices shown for the common stock are historical and not indicative of future price performances.

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ITEM 6. SELECTED FINANCIAL DATA

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

	For the Years Ended December 31,				
	2010	2009	2008	2007	2006
	(in thousands, except per share data)				
Statement of Income Data					
Revenue	$ 275,362	$ 227,389	$ 243,524	$ 205,068	$ 171,083
Cost of revenue	79,740	69,715	73,715	62,505	49,673
Gross margin	195,622	157,674	169,809	142,563	121,410
Operating expenses:					
Research and development	32,550	29,021	28,698	25,872	20,183
Sales, general and administrative	136,156	115,208	118,679	112,240	97,391
Total operating expenses	168,706	144,229	147,377	138,112	117,574
Other income:					
Interest income	669	2,159	9,089	9,662	3,683
Interest expense	(9,416)	(9,918)	(16,313)	(8,120)	
Other (loss) income	(3,772)	(422)	4,133	1,274	294
Total other (loss) income	(12,519)	(8,181)	(3,091)	2,816	3,977
Income before income taxes	14,397	5,264	19,341	7,267	7,813
Income tax provision	4,425	1,981	8,119	2,748	582
Net income	$ 9,972	$ 3,283	$ 11,222	$ 4,519	$ 7,231
Net income per share:					
Basic	$ 0.69	$ 0.19	$ 0.66	$ 0.27	$ 0.44
Diluted	$ 0.66	$ 0.19	$ 0.64	$ 0.26	$ 0.43
Shares used in computing net income per share:					
Basic	14,506	17,239	16,892	16,621	16,274
Diluted	15,028	17,698	17,486	17,168	16,857

	As of December 31,				
	2010	2009	2008	2007	2006
	(in thousands)				
Balance Sheet Data					
Cash and cash equivalents	$ 78,690	$ 183,065	$ 209,258	$ 188,701	$ 45,673
Working capital	168,343	343,092	353,479	384,632	147,302
Total assets	329,055	422,974	426,882	456,707	211,894
Long-term debt, net	97,379	92,905	111,336	165,004	
Total shareholders equity	152,890	254,430	251,060	229,462	181,031

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

Overview

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

Our business strategy is to lead in the design, development and commercialization of high performance, innovative ultrasound technology and hand-carried 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. We are focused on increasing sales force efficiency and effective cost management.

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.

In June 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. 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 both the clinical point-of-care markets, and the pre-clinical markets.

Over the last few years, we have laid a foundation for long-term growth through expansion in four vertical markets including acute, primary care, musculoskeletal, 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 2011, 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 distribution channels, to improve sales productivity, delivering high quality products, and managing the expense structure.

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 2010 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 system, which is based on our fourth generation product platform, and we acquired the BioZ product line from CDIC. We will continue to release new and innovative products in 2011.

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Sales and Marketing Our sales and marketing organization will continue to focus on creating greater awareness of the benefits of point-of-care ultrasound in order to better penetrate established markets, accelerate growth in emerging markets and identify new markets. Over the past two years we have implemented a strategy in our sales channels to better cover key accounts and drive awareness of the safety, cost and efficiency benefits of point-of-care at the institutional level. We believe that this will continue to help us more effectively address considerations that are important at the administrative level, and that complement the clinical benefits we have been communicating at the clinician level. We intend to expand VisualSonics geographic market coverage to

better address the growth opportunities outside of North America. Additionally, we intend to augment the resources we have to address attractive growth opportunities in emerging economies for our entire business.

Strategic Relationships and Acquisitions We are focused on building relationships and gaining access to products and technologies that will enable us to continue to penetrate and develop point-of-care visualization. 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. In 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 point-of-care visualization market in the emergency medical services segment. During 2010, we invested in Carticept Medical Inc. (Carticept), a privately held company that develops innovative injection products for the treatment of musculoskeletal injuries. We believe this relationship will expand our access to the market segment for ultrasound-guided injections.

Results of Operations

The overall market environment improved in 2010 versus 2009. The increase in revenue over the prior year was due to improved execution against our market strategies and partially attributable to the acquisition of VisualSonics on June 30, 2010. Our financial performance during 2010 reflected an increase in revenue, operating income, and cash flows. We believe our strong and growing product pipeline, alongside our expanding distribution capability, has positioned us well to capitalize on a growing market for point of care ultrasound. As we enhance our product offerings, integrate the acquisition of VisualSonics and develop strategic alliances, we believe opportunities to increase revenue will grow.

The following financial information sets forth our results of operations and is derived from our consolidated financial statements (in thousands except percentages):

	Year Ended December 31,					
	2010		2009		2008	
Revenue	$ 275,362	100.0%	$ 227,389	100.0%	$ 243,524	100.0%
Cost of revenue	79,740	29.0	69,715	30.7	73,715	30.3
Gross margin	195,622	71.0	157,674	69.3	169,809	69.7
Operating expenses:						
Research and development	32,550	11.8	29,021	12.8	28,698	11.8
Sales, general and administrative	136,156	49.4	115,208	50.7	118,679	48.7
Total operating expenses	168,706	61.3	144,229	63.4	147,377	60.5
Operating income	26,916	9.8	13,445	5.9	22,432	9.2
Total other loss, net	12,519	4.5	8,181	3.6	3,091	1.3
Income before income taxes	14,397	5.2	5,264	2.3	19,341	7.9
Income tax provision	4,425	1.6	1,981	0.9	8,119	3.3
Net income	$ 9,972	3.6%	$ 3,283	1.4%	$ 11,222	4.6%

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Revenue

Overall revenue increased in 2010 compared to 2009 due primarily to organic growth in all sales channels, and, revenue of $17.6 million from VisualSonics. The decrease in 2009 compared to 2008 was attributable primarily to fewer customer purchases as a result of the global financial crisis combined with uncertainties about healthcare reform in the U.S. Changes in exchange rates had a 0.5% favorable impact on revenue in 2010 and had a 2% unfavorable impact on revenue in 2009. Revenue is as follows (in thousands except percentages):

	Year ended December 31,			Percentage Change	
	2010	2009	2008	2010 Versus 2009	2009 Versus 2008
United States	$ 133,026	$ 104,257	$ 118,378	28%	(12)%
International	124,710	123,132	125,146	1%	(2)%
VisualSonics	17,626				
Total revenue	$ 275,362	$ 227,389	$ 243,524	21%	(7)%

United States

U.S. revenue increased in 2010 compared to 2009 due primarily to an increase in direct sales, enterprise sales and a full year of revenue from CDIC, compared to 5 months in the prior year. The decrease in 2009 compared to 2008 was attributable to decreased sales in both hospital and office channels, partially offset by the acquisition of CDIC during the third quarter of 2009.

International

International revenue increased in 2010 compared to 2009 primarily due to increased revenue from Asia Pacific, most of Europe, and Latin America. These increases were offset by countries impacted by the fiscal austerity measures during the last quarter of 2010. The decrease in 2009 compared to 2008 was primarily due to decreased sales in Europe resulting from a slowdown in European hospital capital spending as a result of the global financial crisis. Changes in exchange rates had a 1.0% favorable impact on revenue in 2010 and had a 3.2% unfavorable impact on revenue in 2009.

Fiscal Year 2011 Outlook

We are targeting revenue to increase 13% to 18% in 2011 compared to 2010. We expect to introduce new products and features, to develop the cardiovascular disease market, and to continue international expansion. We expect revenue growth to increase as new technology introductions from VisualSonics arrive in the market and the impact from recent investments in our business channels take effect. Our revenue may be negatively impacted by sustained global economic challenges.

Gross margin

	Years ended December 31,			Percentage of Revenue		
	2010	2009	2008	2010	2009	2008
Gross Margin	$ 195,622	$ 157,674	$ 169,809	71.0%	69.3%	69.7%

Gross margin increased in 2010 compared to 2009 primarily as a result of an improved product mix, geographic mix, and licensed revenues, offset by slightly lower margins of VisualSonics. Gross margin in 2009 compared to 2008 were slightly lower as the favorably impact of product mix and material costs was offset by unfavorable foreign currency impact and the introduction of a new product that had a lower gross margin.

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Operating expenses

	Years ended December 31,			Percentage of Revenue		
	2010	2009	2008	2010	2009	2008
Research and development	$ 32,550	$ 29,021	$ 28,698	11.8%	12.8%	11.8%
Sales, general, and administrative	$ 136,156	$ 115,208	$ 118,679	49.4%	50.7%	48.7%

Research and development expenditures increased in 2010 compared to 2009 due to the acquisition of VisualSonics as well as continued investment in future technologies that we expect will result in introducing several new products over the next 18 months. The increase in expenditures in 2009 compared to 2008 was due to development of future new products and features, and further development related to the M-Turbo system and S Series ultrasound tools.

Sales, general and administrative expenses increased in 2010 compared to 2009 primarily from to the addition of VisualSonics and associated acquisition and integration costs, as well as restructuring costs. The decrease in 2009 compared to 2008 resulted primarily from decreases in legal expenses, stock based compensation and sales compensation expense, offset by the addition of CDIC and associated acquisition and integration costs.

Other loss, net

	Years ended December 31,			Percentage of Revenue		
	2010	2009	2008	2009	2009	2008
Other loss	$ 12,519	$ 8,181	$ 3,091	4.5%	3.6%	1.3%

Total other loss increased in 2010 compared to 2009 due to no gains recognized on the repurchase of our debt, a reduction in interest income due to a decrease in investment balances and increased foreign exchange losses offset by lower interest expense on our debt due to less outstanding debt. The increase in 2009 compared to 2008 was due to lower gains recognized on the repurchase of our debt and a reduction in interest income, resulting from lower interest rates, offset by lower interest expense on our debt due to less outstanding debt.

Income tax expense

	Years ended December 31,			Effective Tax Rate		
	2010	2009	2008	2010	2009	2008
Income tax provision	$ 4,425	$ 1,981	$ 8,119	30.8%	37.6%	42.0%

The income tax expense is based on a blended federal and state rate applied to U.S. income and the applicable foreign rates applied to foreign income. The decrease in our consolidated effective tax rate in 2010, as compared to 2009, results from an increase in the domestic production deduction, the benefit of positive resolution of various uncertain tax positions in foreign jurisdictions, decreases in non-deductible executive compensation and other expenses and reduction of the impact of the valuation allowance, offset by an increased federal statutory rate due to growth in taxable income and a decrease for research and experimentation credits . The decrease in our consolidated effective tax rate in 2009, as compared to 2008, resulted from a reduced federal statutory rate due to a decline in taxable income and an increase for research and experimentation credits, offset by increases in non-deductible expenses, an increase to the liability for uncertain tax positions and establishment of a valuation allowance on our capital loss carryforwards.

We assess our ability to realize our tax credit carryforwards and deferred tax assets in future periods and record any resulting adjustments that may be required to deferred income tax expense. In addition, we reduce our deferred income tax asset for the benefits of NOL carryforwards utilized currently as well as the reversing effect of temporary differences.

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Liquidity and Capital Resources

Our cash and cash equivalents balance was $78.7 million as of December 31, 2010, compared to $183.1 million as of December 31, 2009. Cash and cash equivalents are primarily invested in money market accounts. We had no short-term investment securities as of December 31, 2010, compared to short-term and long-term investment securities $74.7 million as of December 31, 2009. Investment securities held at the end of 2009 and 2008 generally consisted of high-grade corporate debt. We had the ability to hold our securities until maturity; however, we classified all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies.

Cash Flows

	Years Ended December 31,		
	2010	2009	2008
Net cash provided by operating activities	$ 22,476	$ 21,048	$ 29,171
Net cash provided by (used in) investing activities	3,747	(14,982)	46,628
Net cash used in financing activities	(130,150)	(29,789)	(56,347)
Effect of exchange rate changes on cash and cash equivalents	(448)	(2,470)	1,105
Net change in cash and cash equivalents	$ (104,375)	$ (26,193)	$ 20,557

Operating activities provided cash of $22.5 million in 2010, compared to cash provided of $21.0 million in 2009 and $29.2 million in 2008. The increase in 2010 compared to 2009 was primarily attributable to improved operational performance, offset by a net decrease in working capital and a increase in the deferred income tax provision. The decrease of cash provided in 2009 compared to 2008 was primarily attributable to reduced operational performance, offset by a net decrease in working capital offset by an increase in long term deferred revenue primarily as a result of a patent settlement.

Investing activities provided cash of $3.7 million in 2010, compared to $15.0 million used in 2009 and $46.6 million provided in 2008. The increase in cash provided in 2010 compared to 2009 was due to the net sales and maturities of investment securities offset by the acquisition of VisualSonics. The increase in cash used in 2009 compared to 2008 was due to the acquisition of CDIC and net purchases of investment securities.

Financing activities used cash of $130.2 million in 2010, used $29.8 million in 2009 and provided $56.3 million in 2008. More cash was used in financing activities in 2010 compared to 2009 primarily due to the repurchase of shares compared to the repurchases of convertible notes in 2009. More cash was used in financing activities in 2009 compared to 2008 primarily due to the repurchases of convertible notes slightly offset by an increase in the repayment of long term obligations.

Off-balance sheet arrangements

During the year ended and as of December 31, 2010, we had no off-balance sheet arrangements, other than obligations under our operating leases reflected in the contractual obligations table below. We are not a party to any derivative transactions except for certain foreign exchange rate hedging transactions that we enter into from time to time, discussed more fully under Foreign currency risk in Item 7A below and the call option and warrant instruments indexed to our common stock.

We provide (i) indemnifications of varying scope and size to our customers and distributors against claims of intellectual property infringement made by third parties arising from the use of our products; (ii) indemnifications of varying scope and size to our customers against third party claims arising as a result of defects in our products; (iii) indemnifications of varying scope and size to consultants against third party claims arising from the services they provide to us; and (iv) guarantees to support obligations of some of our

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subsidiaries such as lease payments. These indemnifications and guarantees require only disclosure. To date, we have not incurred material costs as a result of these obligations and do not expect to incur material costs in the future. Accordingly, we have not accrued any liabilities in our consolidated financial statements related to these indemnifications or guarantees.

Contractual obligations

We have the following contractual obligations as of December 31, 2010:

	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
			(in thousands)		
Operating lease obligations	$ 11,077	$ 4,092	$ 5,950	$ 935	$ 100
Long-term debt obligations (1)	132,701	4,766	10,244	117,502	189
Other long-term obligations (2)	2,550	300	2,250		
Total Contractual Obligations	$ 146,328	$ 9,158	$ 18,444	$ 118,437	$ 289

(1) Includes interest of 3.75% on convertible senior notes and interest of 5.9% and 5.3% on bank loans assumed in the acquisition of CDIC
(2) Represents minimum purchase consideration for the acquisition of LumenVu.
In addition to the amounts shown in the table above, we have $3.5 million of unrecognized tax benefits reflected as either liabilities or as a reduction of deferred tax assets, and we are uncertain as to if or when such amounts may be incurred.

Other commitments

In 2010 we entered into a joint distribution agreement with Carticept, which requires us to procure a minimum number of Carticept products in 2012 that will be determined based on distribution activity in 2011.

In June 2008, we committed to donating 12 of our systems and two probes per system per year over a four-year period to a research university commencing in 2010 for use in clinical research. As of December 31, 2010, we anticipate shipping the first systems in early 2011.

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

In certain countries, we have complemented our direct sales efforts by entering into group purchasing agreements with major healthcare GPOs. Typically, a GPO negotiates with medical suppliers, such as us, on behalf of the GPO s member healthcare facilities, providing such members with uniform pricing and terms and conditions. In exchange, the GPO identifies us as a preferred supplier for its members. Member facilities participating in the GPO s purchasing program can consist of hospitals, medical group practices, nursing homes, surgery centers, managed care organizations, long term care facilities, clinics and integrated delivery networks. These agreements require us to pay fees based on the amount of sales generated from these agreements. We recorded fees related to these agreements as sales, general, and administrative expenses of $2.4 million in 2010, $1.9 million in 2009 and $2.1 million in 2008.

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Critical Accounting Policies and Estimates

Our critical accounting policies are discussed in Note 2: *Summary of Significant Accounting Policies* of the Notes to the Consolidated Financial Statements. Our consolidated financial statements and accompanying notes are prepared in accordance with U.S. generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenue, and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to product returns, bad debts, inventories, investments, warranty obligations, service contracts, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. The results form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Critical accounting policies for us include revenue recognition, business combinations, valuation of inventories, warranty expense, income taxes, stock-based compensation, goodwill and other intangible assets and convertible debt and hedge transaction.

Revenue recognition. We recognize revenue on products and accessories when goods are shipped under an agreement with a customer, risk of loss and title have passed to the customer, sales returns are estimable and collection of any resulting receivable is reasonably assured. Revenue is recorded net of any discounts, trade-in allowances, and estimated returns. We estimate returns by reviewing our historical returns, considering customer reaction to new product introductions and current economic conditions. We separately price and sell product upgrades to our customers. We recognize licensing revenue using the proportional performance method, a ratable recognition approach over the life of the license. In addition to a standard warranty, we offer extended warranty and service contracts for coverage beyond the standard warranty period or coverage above what is covered by a standard warranty. Those service contracts are recorded as deferred revenue. For extended warranty and service contracts, revenue is recognized as services are provided or over the term of the contract.

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

Our sales arrangements may contain multiple elements, which include hardware and software products. For the vast majority of our shipments, all deliverables are shipped together. However, in cases some elements of a multiple element arrangement are not delivered as of a reporting date. In September 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards related to revenue recognition for arrangements with multiple deliverables and include some software elements. 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 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.

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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. Adoption of these pronouncements did not have a material effect on the consolidated Financial Statements.

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. The cost of acquisition for VisualSonics was more than the fair value of the net assets of the subsidiary acquired, the excess of the value of the net assets acquired over the purchase price has been recorded as goodwill. We recorded identifiable assets including customer relationships, developed technology, trademarks, and internally developed software, which have lives from two to twenty-five years.

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

Valuation of inventories. Inventories are stated at the lower of cost or market on a first-in, first-out method. Included in our inventories balance are demonstration products used by our sales representatives and marketing department. Adjustments to reduce carrying costs to their net realizable values are recorded for obsolete material, shrinkage, earlier generation products and used or refurbished products held either as saleable inventory or as demonstration product.

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

Warranty expense. We accrue estimated warranty expense at the time of sale for costs expected to be incurred under our product warranties. This provision for warranty expense is made based upon our historical and anticipated product failure rates and service repair costs using management s judgment. We have limited history with some of our products. We provide, with certain exceptions, a five-year warranty with the NanoMaxx, M-Turbo, S Series, MicroMaxx, and BioZ systems. Given the length of the warranty period, the warranty liability for these systems is more difficult to estimate than it has been for our other products that have a one-year warranty. However, given the similarity of the components used in the NanoMaxx system, M-Turbo system, and S Series ultrasound tools compared with our MicroMaxx system and the historical product failure rate and service repair costs of the MicroMaxx and the other systems, we believe that we can reasonably estimate the amount of the warranty liability for these products. We expect our warranty liability and expense to continue to increase due to the five-year warranty offered with these products. Should actual failure rates or repair or replacement costs for any of our products differ from estimates, revisions to the estimated warranty liability may be required and our results may be materially affected.

Income taxes. The process of accounting for income taxes involves calculating our current tax obligation or refund and assessing the nature and measurements of temporary differences resulting from differing treatment of

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

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

We have accumulated foreign NOL carryforwards and research and experimentation tax credit carryforwards. During 2010, with the acquisition of VisualSonics, we acquired various foreign tax attribute carryforwards including research and experimentation expenditure pool, net operating loss, and research and experimentation taxes. Additionally, during 2009, with the acquisition of CDIC we acquired U.S. federal and state NOL carryforwards. We assess our ability to utilize these foreign attribute carryforwards in future periods and record any resulting adjustments that may be required to deferred income tax expense. In addition, we reduce the deferred income tax asset for the benefits of NOL and tax credit carryforwards utilized currently.

Based upon a review of historical operating performance, and our expectation that we will generate profits in the U.S. and our international operations in the foreseeable future, we continue to believe it is more likely than not that the U.S. and international deferred tax assets will be fully realized with the exception of $0.4 million related to capital loss carryforward, $1.2 million related to CDIC state NOL carryforward, and $0.4 million related to VisualSonics net deferred tax asset.

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

Changes in these inputs and assumptions can materially affect the measure of estimated fair value of our stock-based compensation. These assumptions are subjective and generally require significant analysis and judgment to develop. When estimating fair value, some of the assumptions will be based on, or determined from, external data and other assumptions may be derived from our historical experience with stock-based payment arrangements. The appropriate weight to place on historical experience is a matter of judgment, based on relevant facts and circumstances. In addition, future grants of equity awards will result in additional compensation expense in future periods.

Goodwill and other intangible assets. We perform goodwill and indefinite lived intangible assets impairment tests in the fourth quarter and more frequently if facts and circumstances indicate reporting unit

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carrying values exceed estimated reporting unit fair values. Intangible assets subject to amortization, which consist mainly of customer relationships, acquired technology, trademarks, and non-compete agreements, are amortized using the straight-line method over their estimated useful lives of three to twenty-five years.

The process of evaluating the potential impairment of goodwill is subjective and requires significant judgment at many points during the analysis, including the identification of our reporting units, identification and allocation of the assets and liabilities to each of our reporting units and determination of fair value. In estimating the fair value of a reporting unit for the purposes of our annual or periodic impairment analyses, we make estimates and significant judgments about the future cash flows of that reporting unit. Our cash flow forecasts are based on assumptions that represent the highest and best use for our reporting units. Changes in judgment on these assumptions and estimates could result in further goodwill impairment charges. We believe that the assumptions and estimates utilized are appropriate based on the information available to management.

We evaluate the recoverability of intangible assets whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. This analysis requires similar significant judgments as those discussed above regarding goodwill, except for cash flows are based on an undiscounted cash flow to determine the fair value of the intangible.

Convertible debt and hedge transaction. On January 1, 2009, we adopted new accounting guidance, which clarifies the accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. We bifurcated a component of the conversion option and classified that component in equity. The value of the equity component was calculated by first measuring the fair value of the liability component, using the discount rate of a similar liability that does not have a conversion feature, as of the issuance date. The difference between the proceeds for the convertible debt and the amount reflected as the liability component was recorded as the equity component. We recognize the accretion of the resulting discount as part of interest expense in our consolidated statements of income.

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

Our interest expense is composed of two parts: the stated rate of the debt and the amortization of the debt discount. Additionally, we have recorded the call option and warrant transactions as equity instruments.

Accounting Pronouncements Issued not yet Adopted

In December 2010, the FASB issued ASU 2010-28, Intangibles Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts, a consensus of the FASB Emerging Issues Task Force (Issue No. 10-A). ASU 2010-28 modifies Step 1 of the goodwill impairment test under ASC Topic 350 for reporting units with zero or negative carrying amounts to require an entity to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are adverse qualitative factors, including the examples provided in ASC paragraph 350-20-35-30, in determining whether an interim goodwill impairment test between annual test dates is necessary. The ASU allows an entity to use either the equity or enterprise valuation premise to determine the carrying amount of a reporting unit. ASU 2010-28 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 for a nonpublic company. The Company expects that the adoption of ASU 2010-28 in 2012 will not have a material impact on its consolidated financial statements.

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In January 2010, the FASB issued ASU 2010-6, Improving Disclosures About Fair Value Measurements, which requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. ASU 2010-6 is effective for annual reporting periods beginning after December 15, 2009, except for Level 3 reconciliation disclosures which are effective for annual periods beginning after December 15, 2010. The adoption of ASU 2010-6 will not have a material impact on our consolidated financial statement disclosures.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate risk

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

As of December, 2010, our investment portfolio consisted of $70.5 million of interest-bearing money market accounts. We believe that the impact on the fair market value of our securities and related earnings for 2010 from a hypothetical 10% increase or decrease 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 trade and intercompany balances denominated in a currency other than US Dollar (USD) and from translation of our foreign subsidiaries operating results. We enter into foreign currency forward and option contracts to reduce the impact of fluctuations on earnings associated with foreign currency exchange rate changes. These foreign currencies include the Australian dollar, the British pound, the Canadian dollar, the European Union euro, and the Japanese yen. We use foreign exchange contracts to mitigate risk and do not intend to engage in speculative transactions. Currently our foreign exchange contracts do not qualify for derivative hedge accounting. We seek to manage the counterparty risk associated with engaging in foreign currency contracts by limiting transactions to counterparties with which we have established banking relationships.

A sensitivity analysis of a change in the fair value of these contracts, totaling $50.2 million in notional amount, indicates that if the USD weakened by 10% against the applicable foreign currency, the fair value of these contracts would decrease by approximately $4.9 million. Conversely, if the USD strengthened by 10% against the applicable foreign currency, the fair value of these contracts would increase by approximately $5.0 million. 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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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

SONOSITE, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

SonoSite, Inc.:

We have audited the accompanying consolidated balance sheets of SonoSite, Inc. and subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of income, cash flows, and shareholders equity and comprehensive income (loss) for each of the years in the three-year period ended December 31, 2010. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule listed in Item 15(a)(2). These consolidated financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of SonoSite, Inc. and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in note 9 to the consolidated financial statements, the Company changed its method of accounting for its convertible senior notes due to the adoption of Financial Accounting Standards Board Staff Position No. APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement) (included in FASB ASC Topic 470-20 Debt with Conversion and Other Options) as of January 1, 2009. This accounting change was accounted for by retrospective application to the consolidated financial statements for all prior periods presented.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), SonoSite Inc. s internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 16, 2011 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting. This report contains an explanatory paragraph stating that the Company acquired VisualSonics, Inc. (VisualSonics) during 2010 and management excluded from its assessment of the effectiveness of SonoSite, Inc. s internal control over financial reporting as of December 31, 2010, VisualSonics internal control over financial reporting associated with total assets of $86.5 million and total revenues of $17.6 million included in the consolidated financial statements of SonoSite, Inc. and subsidiaries as of and for the year ended December 31, 2010. Our audit of internal control over financial reporting of SonoSite, Inc. also excluded an evaluation of the internal control over financial reporting of VisualSonics.

/s/ KPMG LLP

Seattle, Washington

March 16, 2011

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

SonoSite, Inc.:

We have audited SonoSite, Inc. s internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). SonoSite s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying management s report on internal control over financial reporting (Item 9A(b)). Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

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

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

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

In our opinion, SonoSite, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

SonoSite, Inc. acquired VisualSonics Inc, (VisualSonics), during 2010, and management excluded from its assessment of the effectiveness of SonoSite, Inc. s internal control over financial reporting as of December 31, 2010, VisualSonics internal control over financial reporting associated with total assets of $86.5 million and total revenues of $17.6 million included in the consolidated financial statements of SonoSite, Inc. and subsidiaries as of and for the year ended December 31, 2010. Our audit of internal control over financial reporting of SonoSite, Inc. also excluded an evaluation of the internal control over financial reporting of VisualSonics.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of SonoSite, Inc. and subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of income, cash flows and shareholders equity and comprehensive income (loss) for each of the years in the three-year period ended December 31, 2010, and our report dated March 16, 2011 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Seattle, Washington

March 16, 2011

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SONOSITE, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	As of December 31, 2010	2009
ASSETS		
Current Assets		
Cash and cash equivalents	$ 78,690	$ 183,065
Investment securities		74,682
Accounts receivable, less allowances of $932 and $1,388	81,516	71,347
Inventories	37,126	32,216
Deferred tax asset, current	7,801	7,350
Prepaid expenses and other current assets	12,384	12,034
Total current assets	217,517	380,694
Property and equipment, net	9,133	9,160
Deferred tax asset, net	4,373	775
Investment in affiliate	8,000	
Goodwill	37,786	3,902
Identifiable intangible assets, net	47,423	24,018
Other assets	4,823	4,425
Total assets	$ 329,055	$ 422,974
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 10,597	$ 6,175
Accrued expenses	32,535	25,923
Deferred revenue, current portion	6,042	5,504
Total current liabilities	49,174	37,602
Long-term debt, net	97,379	92,905
Deferred tax liability	1,811	5,083
Deferred revenue, net	15,236	18,081
Other non-current liabilities, net	12,565	14,873
Total liabilities	176,165	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, $0.01 par value Shares authorized 50,000,000 Issued and outstanding shares:		
As of December 31, 2010 and 2009 13,539,633 and 17,354,355	135	174
Additional paid-in capital	298,870	287,496
Accumulated deficit	(148,975)	(32,886)
Accumulated other comprehensive income (loss)	2,860	(354)
Total shareholders equity	152,890	254,430

Total liabilities and shareholders equity	$ 329,055	$ 422,974

See accompanying notes to the consolidated financial statements.

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SONOSITE, INC.

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

	For the Years Ended December 31,		
	2010	**2009**	**2008**
Revenue	$ 275,362	$ 227,389	$ 243,524
Cost of revenue	79,740	69,715	73,715
Gross margin	195,622	157,674	169,809
Operating expenses:			
Research and development	32,550	29,021	28,698
Sales, general and administrative	136,156	115,208	118,679
Total operating expenses	168,706	144,229	147,377
Other income and (expense):			
Interest income	669	2,159	9,089
Interest expense	(9,416)	(9,918)	(16,313)
Gain on convertible note repurchase		1,100	8,246
Other expense, net	(3,772)	(1,522)	(4,113)
Total other loss, net	(12,519)	(8,181)	(3,091)
Income before income taxes	14,397	5,264	19,341
Income tax provision	4,425	1,981	8,119
Net income	$ 9,972	$ 3,283	$ 11,222
Net income per share:			
Basic	$ 0.69	$ 0.19	$ 0.66
Diluted	$ 0.66	$ 0.19	$ 0.64
Weighted average common and potential common shares outstanding:			
Basic	14,506	17,239	16,892
Diluted	15,028	17,698	17,486

See accompanying notes to the consolidated financial statements.

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SONOSITE, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	For the Years Ended December 31,		
	2010	**2009**	**2008**
Operating activities:			
Net income	$ 9,972	$ 3,283	$ 11,222
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	8,176	5,352	4,125
Stock-based compensation	6,377	6,552	8,709
Deferred income tax provision (benefit)	(5,073)	427	3,551
Amortization of debt discount and debt issuance costs	4,895	5,015	8,305
Excess tax benefit from stock-based compensation	(1,188)	(144)	(1,025)
Gain on convertible note repurchase		(1,100)	(8,246)
Gain on bargain purchase of CardioDynamics		(1,099)	
Other	1,078	730	855
Changes in operating assets and liabilities:			
Accounts receivable	(6,318)	(3,013)	(6,273)
Inventories	564	153	194
Prepaid expenses and other assets	596	(3,133)	1,391
Accounts payable	2,573	(2,329)	(2,624)
Accrued expenses	3,381	(9,613)	10,014
Deferred revenue	(2,307)	19,463	(1,453)
Deferred liabilities	(252)	504	426
Net cash provided by operating activities	22,474	21,048	29,171
Investing activities:			
Purchase of investment securities	(79,921)	(142,147)	(248,124)
Proceeds from the sales/maturities of investment securities	154,698	138,323	298,514
Purchase of property and equipment	(1,590)	(2,586)	(2,841)
Investment in affiliates	(8,000)		
Purchase of CardioDynamics, net of cash acquired		(8,185)	
Purchase of VisualSonics, Inc, net of cash acquired	(61,440)		
Earn-out consideration for SonoMetric Health, Inc.		(387)	(921)
Net cash provided by (used in) investing activities	3,747	(14,982)	46,628
Financing activities:			
Excess tax benefit from exercise stock-based awards	1,188	144	1,025
Minimum tax withholding on stock-based awards	(1,212)	(1,342)	
Stock repurchases including transaction costs	(126,103)		
Payment of contingent purchase consideration for LumenVu, Inc.	(425)		
Proceeds from exercise of stock-based awards and employee stock purchase plan	5,267	1,769	4,551
Retirement of convertible debt		(30,492)	(62,406)
Proceeds from sale of call options		1,646	6,417
Repayment of long-term debt	(8,865)		
Purchase of warrants		(1,514)	(5,934)
Net cash used in financing activities	(130,150)	(29,789)	(56,347)
Effect of exchange rate changes on cash and cash equivalents	(446)	(2,470)	1,105
Net change in cash and cash equivalents	(104,375)	(26,193)	20,557

Cash and cash equivalents at beginning of year	183,065	209,258	188,701
Cash and cash equivalents at end of year	$ 78,690	$ 183,065	$ 209,258
Supplemental disclosure of cash flow information:			
Cash paid for income taxes	$ 10,452	$ 4,329	$ 2,777
Cash paid for interest	$ 4,481	$ 5,286	$ 9,323

See accompanying notes to the consolidated financial statements.

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SONOSITE, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

AND COMPREHENSIVE INCOME (LOSS)

(in thousands, except shares)

	Common Stock		Additional paid-in capital	Accumulated deficit	Accumulated other comprehensive income (loss)	Total shareholders equity
	Shares	Amount				
Balance at December 31, 2007	16,746,017	$ 167	$ 275,256	$ (47,391)	$ 1,430	$ 229,462
Comprehensive income:						
Net income				11,222		11,222
Net unrealized gain on investment securities, net of tax of $118					248	248
Less reclassification adjustment for gain included in net income					(47)	(47)
Foreign currency translation adjustment					(463)	(463)
Comprehensive income						10,960
Equity component of convertible senior notes			(10,943)			(10,943)
Net tax liability from equity component of convertible senior notes			7,012			7,012
Exercise of stock options and employee stock purchase plan	260,254	3	4,548			4,551
Tax benefit from exercise of stock options, net			865			865
Tax benefit related to original issue discount on the convertible senior notes			1,231			1,231
Tax provision related to cancelation of debt			(803)			(803)
Stock-based compensation			8,676			8,676
Restricted stock units vested, net of 13,574 shares retired	48,426	1	(435)			(434)
Sale of call option			6,417			6,417
Repurchase of warrants			(5,934)			(5,934)
Balance at December 31, 2008	17,054,697	171	285,890	(36,169)	1,168	251,060
Comprehensive income:						
Net income				3,283		3,283
Net unrealized loss on investment securities, net of tax of $122					(79)	(79)
Less reclassification adjustment for gain included in net income					(130)	(130)
Foreign currency translation adjustment					(1,313)	(1,313)
Comprehensive income						1,761
Equity component of convertible senior notes			(3,512)			(3,512)
Net deferred tax liability from equity component of debt component			2,435			2,435
Exercise of stock options and employee stock purchase plan	115,689	1	1,768			1,769

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SONOSITE, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

AND COMPREHENSIVE INCOME (LOSS)

(in thousands, except shares)

(continued)

	Common Stock					
	Shares	Amount	Additional paid-in capital	Accumulated deficit	Accumulated other comprehensive income (loss)	Total shareholders equity
Tax shortfalls from stock-based compensation, net			(2,308)			(2,308)
Tax benefit related to original issue discount on the convertible senior notes			(1,183)			(1,183)
Tax benefit related to cancelation of debt			(933)			(933)
Stock-based compensation			6,552			6,552
Restricted stock units vested, net of 66,909 shares retired	183,969	2	(1,344)			(1,342)
Sale of call option			1,645			1,645
Repurchase of warrants			(1,514)			(1,514)
Balance at December 31, 2009	17,354,355	174	287,496	(32,886)	(354)	254,430
Comprehensive income:						
Net income				9,972		9,972
Net unrealized loss on investment securities, net of tax of $3					92	92
Less reclassification adjustment for losses included in net income					(1)	(1)
Foreign currency translation adjustment					3,123	3,123
Comprehensive income						13,186
Exercise of stock options	290,456	2	5,265			5,267
Tax benefit from stock-based compensation, net			945			945
Stock-based compensation			6,377			6,377
Restricted stock units vested, net of 42,543 shares retired	135,796	1	(1,213)			(1,212)
Repurchase of stock	(4,240,974)	(42)		(126,061)		(126,103)
Balance at December 31, 2010	13,539,633	$ 135	$ 298,870	$ (148,975)	$ 2,860	$ 152,890

See accompanying notes to the consolidated financial statements.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Business Overview

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

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

2. Summary of Significant Accounting Policies

Basis of presentation and use of estimates

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

Cash equivalents

Cash equivalents primarily consist of money market accounts with major U.S. banks and highly liquid debt instruments with maturities at purchase of three months or less.

Investment securities

Investment securities primarily consist of high-grade 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. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis.

A decline in market value of any available-for-sale security below cost that is determined to be other than temporary results in a revaluation of its carrying amount to fair value. The impairment related to credit losses is charged to earnings and a new cost basis for the security is established. The impairment related to other factors is recognized in other comprehensive income. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Interest income is recognized when earned. We may incur unrealized losses due to changes in market value attributable to changes in interest rates. We have the ability and intent to hold our investments until a recovery of cost, which may be maturity. All investment securities matured during 2010.

Accounts receivable

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We regularly evaluate the collectability of our trade receivables based on a combination of factors, including a dialogue with the customer to determine the cause of non-payment, and

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

evaluation of the customer s current financial situation. In the event it is determined that the customer may not be able to meet its full obligation to us, we record a specific allowance to reduce the receivable to the amount that we expect to recover given all information present. We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and our assessment of the customer s current credit worthiness. We continuously monitor collections from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that we have identified. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates in the future. If the financial condition of our customers were to deteriorate, for example as a result of the recent financial and economic turmoil or otherwise, resulting in an impairment of their ability to make payments, additional allowances may be required.

In the ordinary course of business, we grant credit to a broad customer base. Of the accounts receivable balance at December 31, 2010, 66% and 34% were receivable from international and domestic customers, prior to any allowance for doubtful accounts. The same percentages as of December 31, 2009 were 67% and 33% prior to any allowance for doubtful accounts.

Fair value of financial instruments

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

The fair value hierarchy is followed in calculating fair values. Quoted market prices are used to calculate the fair value for assets or liabilities with an active market (Level 1). Other quoted prices are used for assets or liabilities similar to those in markets that are not active or with inputs other than quoted prices that are observable and market corroborated inputs (Level 2). Where quoted market prices or other quoted prices are unavailable significant unobservable inputs are used to measure fair value (Level 3).

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

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 or our competitors impacts the markets for our previously released products, we may be required to further write down the carrying cost of our inventories.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

Property and equipment

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

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

Asset	Estimated Useful Lives
Equipment and computers	3 5 years
Software	3 years
Furniture and fixtures	5 years
Building	25 years
Leasehold improvements	Lesser of estimated useful life or remaining lease term

The carrying value of long-lived asset groups is evaluated for impairment when events or changes in circumstances occur that may indicate the carrying amount of the asset group may not be recoverable. For depreciable property and equipment and amortizable intangible assets, we evaluate the carrying value of the asset group by comparing the estimated future undiscounted cash flows generated from the use of the asset group and its eventual disposition with the asset group s net book value. If the estimated future undiscounted cash flows from an asset group are less than the net book value of the asset group, we record an impairment loss equal to the excess of the net book value over the estimated fair market value of the asset group.

Goodwill and other intangible assets

We perform goodwill and indefinite lived intangible assets impairment tests in the fourth quarter and more frequently if facts and circumstances indicate reporting unit carrying values exceed estimated reporting unit fair values. Intangible assets subject to amortization, which consist mainly of customer relationships, acquired technology, trademarks, and non-compete agreements, are amortized using the straight-line method over their estimated useful lives of three to twenty-five years.

The process of evaluating the potential impairment of goodwill and indefinite lived intangible assets is subjective and requires significant judgment at many points during the analysis, including the identification of our reporting units, identification and allocation of the assets and liabilities to each of our reporting units and determination of fair value. In estimating the fair value of each reporting unit for the purposes of our annual or periodic impairment analyses, we relied upon estimates and significant judgments about the future cash flows and considered the market value of our publicly traded stock. Changes in judgment on these assumptions and estimates could result in goodwill impairment charges. We believe that the assumptions and estimates utilized are appropriate based on the information available to management.

We evaluate the recoverability of intangible assets whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. This analysis requires similar significant judgments as those discussed above regarding goodwill, except for cash flows are based on an undiscounted cash flow to determine the fair value of the intangible.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

Concentration of credit and supply risk

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

We depend on some single-source suppliers to provide highly specialized parts and other components, and may experience an interruption of supply if a supplier is unable or unwilling to meet our time, quantity and quality requirements. There are relatively few alternative sources of supply for some of these items. A change in demand for some parts by other companies in our industry could also interrupt our supply of components.

Our circuit boards are produced by a large electronic manufacturing services supplier who produces the boards in their manufacturing facility in Malaysia. If we experience delays in the receipt or deterioration in product yields of these components, we may experience delays in manufacturing or an increase in costs resulting in lost sales or deterioration in gross margin.

Revenue recognition

We recognize revenue on products and accessories when goods are shipped under an agreement with a customer, risk of loss and title have passed to the customer, sales returns are estimable and collection of any resulting receivable is reasonably assured. Revenue is recorded net of any discounts, trade-in allowances, and estimated returns. We estimate returns by reviewing our historical returns, considering customer reaction to new product introductions and current economic conditions. We make product upgrades available for purchase to our customers. We recognize licensing revenue using the proportional performance method, a ratable recognition approach over the life of the license. In addition to a standard warranty, we offer extended warranty and service contracts for coverage beyond the standard warranty period or coverage above what is covered by a standard warranty. Those service contracts are recorded as deferred revenue. For extended warranty and service contracts, revenue is recognized as services are provided or over the term of the contract.

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

Our sales arrangements may contain multiple elements, which include hardware and software products. For the vast majority of our shipments, all deliverables are shipped together. However, in some cases certain elements of a multiple element arrangement are not delivered as of a reporting date. In September 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards related to revenue recognition for arrangements with multiple deliverables and include some software elements. 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

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

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. When the undelivered element represents services under extended service contracts, revenue equal to the stated price, less any allocable discount on the overall multi-element arrangement is deferred and recognized evenly over the contract term as those services are provided. Adoption of these pronouncements did not have a material effect on the consolidated financial statements.

Warranty expense

We generally offer a five year warranty for our products. 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 using management s judgment based upon our historical and anticipated product failure rates and service repair costs. Our warranty period for certain older generation products is one year. We periodically assess the adequacy of the warranty reserve and adjust the amount as necessary. The warranty is included with the original purchase.

Research and development

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

Advertising costs

We expense costs for advertising and promotional activities as incurred. Advertising and promotional expenses for the years ended December 31, 2010, 2009 and 2008 were $10.0 million, $9.7 million, and $9.4 million.

Income taxes

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

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

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

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

Stock-based compensation

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

Net income per share

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

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

	Year Ended December 31,		
	2010	2009	2008
Net income	$ 9,972	$ 3,283	$ 11,222
Weighted average common shares outstanding used in computing basic net income per share	14,506	17,239	16,892
Effect of dilutive stock options and unvested restricted stock units	522	459	594
Weighted average common and potential common shares outstanding used in computing diluted net income per share	15,028	17,698	17,486
Net income per share:			
Basic	$ 0.69	$ 0.19	$ 0.66
Diluted	$ 0.66	$ 0.19	$ 0.64

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

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

	Year Ended December 31,		
	2010	2009	2008
Stock options and unvested restricted stock	679	875	639
Warrants outstanding (1)	1,121	1,121	1,497
Total common shares excluded from diluted net income per share	1,800	1,996	2,136

(1) As further detailed in note 9, in July 2007 we issued warrants to purchase up to 2.5 million shares of our common stock with a strike price of $46.965, which are anti-dilutive since the strike price of the warrants is greater than the market price of our common stock. In 2009 and 2008, we repurchased warrants that were for the purchase of up to 0.4 million and 1.0 million shares respectively.

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

Accumulated other comprehensive income (loss)

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

The following are the components of accumulated other comprehensive income (loss) (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Net unrealized (loss) gain on investments, net of tax	$	$ (91)	$ 118
Cumulative translation adjustments	2,860	(263)	1,050
Total accumulated other comprehensive income (loss)	$ 2,860	$ (354)	$ 1,168

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 of our international subsidiaries are translated at the exchange rate on the balance sheet date. Revenues, costs and expenses and cash flows of our international subsidiaries are translated at average exchange rates of in effect during the period.

Accounting pronouncements issued not yet adopted

In December 2010, the FASB issued ASU 2010-28, Intangibles Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts, a consensus of the FASB Emerging Issues Task Force (Issue No. 10-A). ASU 2010-28 modifies Step 1 of the goodwill impairment test under ASC Topic 350 for reporting units with zero or negative carrying amounts to

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Summary of Significant Accounting Policies (Continued)

require an entity to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are adverse qualitative factors, including the examples provided in ASC paragraph 350-20-35-30, in determining whether an interim goodwill impairment test between annual test dates is necessary. The ASU allows an entity to use either the equity or enterprise valuation premise to determine the carrying amount of a reporting unit. ASU 2010-28 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 for a nonpublic company. The Company expects that the adoption of ASU 2010-28 in 2012 will not have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU 2010-6, Improving Disclosures About Fair Value Measurements, which requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. ASU 2010-6 is effective for annual reporting periods beginning after December 15, 2009, except for Level 3 reconciliation disclosures which are effective for annual periods beginning after December 15, 2010. The adoption of ASU 2010-6 will not have a material impact on our consolidated financial statement disclosures.

3. Cash, cash equivalents and investment securities

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

	As of December 31,	
	2010	2009
Cash	$ 8,217	$ 7,858
Cash equivalents:		
Corporate bonds		13,999
Money market accounts	70,473	161,208
Total cash and cash equivalents	$ 78,690	$ 183,065
Investment securities:	$	$ 74,682

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 consisted of high-grade corporate debt. We had the ability to hold our securities until maturity; however, we classified 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 were traded in active markets (Level 1) and matured during 2010.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
2010:				
Cash equivalents:				
Money market accounts	$ 70,473	$	$	$ 70,473
Total cash equivalents	$ 70,473	$	$	$ 70,473
2009:				
Cash equivalents:				
Corporate bonds	$ 13,996	$ 3	$	$ 13,999
Money market accounts	161,208			161,208
Total cash equivalents	$ 175,204	$ 3	$	$ 175,207
Investments:				
Corporate bonds	$ 74,668	$ 18	$ (4)	$ 74,682
Total investments	$ 74,668	$ 18	$ (4)	$ 74,682

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

	Year ended December 31,		
	2010	2009	2008
Gains	$	$ 130	$ 12
Losses	(1)		(59)
Realized gain (loss), net	$ (1)	$ 130	$ (47)

As of December 31, 2009, our investment in the Columbia Strategic Cash Portfolio has been liquidated. As of December 31, 2008, all investments other than this portfolio were Level 1 investments. We had an investment of $2.8 million invested in this portfolio. Distributions from this portfolio were solely at the discretion of the portfolio manager. This investment had been measured at fair value using significant unobservable inputs (Level 3), which was estimated to approximate the net asset value of the portfolio provided by the portfolio manager. The portfolio manager measured the net asset value based upon quoted market prices of comparable securities, as well as good faith estimates. Other-than-temporary impairments, all of which related to the Columbia Strategic Cash Portfolio, represented credit losses and are recognized in other income (loss) with no amount recorded in accumulated other comprehensive income.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

The following table summarizes activity for the fair value measurements of significant unobservable inputs (Level 3) investments (in thousands):

	December 31, 2009
Balance, at beginning of period	$ 2,765
Total gain (loss) (realized or unrealized) included in:	
Other income (loss)	125
Other comprehensive loss	
Distributions	(2,890)
Balance, at end of period	$
Gains (losses) included in other income (loss) attributable to the change in unrealized losses relating to assets still held	$

4. Financial statement detail as of December 31, 2010 and 2009

The following provides additional information concerning selected balance sheet accounts (in thousands):

	As of December 31, 2010	2009
Inventories		
Raw materials	$ 13,671	$ 9,177
Demonstration product	13,008	12,317
Finished goods	10,447	10,722
Total inventories	$ 37,126	$ 32,216
Property and equipment, net		
Equipment, other than computer	$ 19,776	$ 17,680
Software	6,712	6,696
Computer equipment	6,056	5,434
Furniture and fixtures	3,159	3,153
Leasehold improvements	3,887	3,683
Buildings	718	771
Land	91	98
	40,399	37,515
Less accumulated depreciation and amortization	(31,266)	(28,355)

Total property and equipment, net	$ 9,133	$ 9,160

Depreciation expense for the years ended December 31, 2010, 2009, and 2008, was $3.2 million, $4.0 million and $4.0 million.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Financial statement detail as of December 31, 2010 and 2009 (Continued)

	As of December 31,	
	2010	**2009**
Accrued expenses		
Payroll and related	$ 16,532	$ 11,448
Taxes	2,485	3,482
Warranty, current portion	3,527	2,432
Accrued interest	1,972	1,970
Foreign exchange hedge settlement	2,471	67
Other	5,548	6,524
Total accrued expenses	$ 32,535	$ 25,923
Other non-current liabilities		
Contingent purchase consideration	$ 2,277	$ 6,145
Deferred rent	1,253	1,525
Warranty liability, net of current portion	6,900	6,000
Other	2,135	1,203
Total other non-current liabilities	$ 12,565	$ 14,873
Deferred revenue		
Current portion	6,042	5,504
Non-current portion	15,236	18,081
Total deferred revenue	$ 21,278	$ 23,585

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

	Year ended December 31,		
	2010	**2009**	**2008**
Beginning of year	$ 8,432	$ 7,094	$ 4,045
Charged to cost of revenue	5,744	3,720	4,773
Applied to liability	(3,879)	(2,683)	(1,724)
Liability acquired	130	301	
End of Year	$ 10,427	$ 8,432	$ 7,094

5. Investment in affiliate

During 2010, we invested $8.0 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. Additionally, our chief executive

officer is on the board of directors. 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-

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investment in affiliate (Continued)

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.

We are a principal owner and distributor of Carticept. During 2010, we have recognized revenue of $1.3 million from Carticept. Accounts receivable from Carticept was $0.3 million as of December 31, 2010.

6. Acquisitions

VisualSonics, Inc.

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. During 2010, the results of VisualSonics operations are included in our consolidated financial statements since the date of acquisition.

Operating expenses include acquisition related charges of $4.2 million for the for the year ended December 31, 2010.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Acquisitions (Continued)

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

	June 30, 2010
Assets	
Current assets:	
Cash and cash equivalents	$ 3,322
Accounts receivable	4,538
Inventories	5,002
Deferred income taxes	1,224
Prepaid expenses and other current assets	1,160
Total current assets	15,246
Property and equipment, net	1,312
Identifiable intangible assets	32,910
Goodwill	31,523
Total assets	$ 80,991
Liabilities	
Current liabilities:	
Accounts payable	$ 1,988
Accrued expenses and other current liabilities	3,409
Deferred revenue	410
Total current liabilities	5,807
Long-term debt	8,828
Deferred tax liabilities	1,223
Other non-current liabilities	371
Total liabilities	16,229
Net assets acquired	$ 64,762

During the measurement period the preliminary amount will be updated based upon new information received related to the facts and circumstances that existed at the acquisition date. During the measurement period through December 31, 2010 we have updated certain provisional amounts and the resulting change decreased deferred income taxes by $1.2 million, increased prepaid expenses and other assets by $0.2 million, increased goodwill by $1.0 million, decreased accounts payable by $0.2 million, increased accrued expenses and other liabilities by $0.1 million, decreased deferred tax liabilities by $0.1 million and decreased net assets acquired by $0.2 million. 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 preliminary amount as part of the acquisition accounting.

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.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Acquisitions (Continued)

We used the following methods to measure fair value of intangible assets:

Developed technology and customer relations were valued using the multi-period excess earnings method

Trademarks were valued using the relief from royalty method

The fair value of the identified intangible assets was estimated by performing a discounted cash flow analysis using the income approach. This method includes a forecast of direct revenues and costs associated with the respective intangible assets and charges for economic returns on tangible and intangible assets utilized in cash flow generation. Net cash flows attributable to the identified intangible assets were discounted to their present value at a rate commensurate with the perceived risk. The projected cash flow assumptions considered contractual relationships, customer attrition and the tax amortization benefit.

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 recognized a deferred tax asset of $8.3 million, which includes foreign net operating loss carryforward of $1.0 million, foreign research and experimentation expense carryforward of $5.1 million, and foreign research and experimentation tax credit carryforward of $1.8 million. Additionally, deferred tax liabilities of $8.3 million were recorded relating to acquired intangible assets. A valuation allowance was established of $0.4 million on the net deferred tax assets of VisualSonics. The net operating loss was generated in 2010 and will expire in 2030. The research and experimentation expense carryforward has an indefinite life and the research and experimentation tax credit carryforwards expire from 2025 through 2030.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Acquisitions (Continued)

The results of VisualSonics operations has been included in our consolidated financial statements since the date of acquisition. For comparability purposes, the following table presents our pro forma revenue and net income (loss) for the twelve months ended December 31, 2010 and 2009, had the VisualSonics acquisition date been January 1, 2009 (in thousands):

	Unaudited	
	Revenue	Net income (loss)
VisualSonics:		
Actual from June 30, 2010 to December 31, 2010	$ 17,626	$ (958)
Supplemental pro forma from the combined entity for the period:		
January 1, 2010 to December 31, 2010 (1)	$ 291,010	$ 8,379
January 1, 2009 to December 31, 2009	$ 266,520	$ (2,191)

(1) Pro forma net income (loss) excluded acquisition and integration charges of $4.2 million.

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

CardioDynamics International Corporation

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.

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

Cash consideration of $10.7 million was transferred for the shares of CDIC and Medis. The results of CDIC s operations have been included in our consolidated financial statements since the date of acquisition.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Acquisitions (Continued)

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):

	August 14, 2009
Assets	
Current assets:	
Cash and cash equivalents	$ 2,511
Accounts receivable	2,627
Inventories	2,885
Deferred income taxes	5,376
Prepaid expenses and other current assets	95
Total current assets	13,494
Property and equipment, net	1,001
Identifiable intangible assets	12,400
Other assets	158
Total assets	$ 27,053
Liabilities	
Current liabilities:	
Accounts payable	$ 2,459
Accrued expenses and other current liabilities	2,191
Total current liabilities	4,650
Long-term debt	5,608
Deferred tax liability	4,562
Other non-current liabilities	437
Total liabilities	15,257
Net assets acquired	11,796
Acquisition consideration	10,697
Gain on bargain purchase	$ 1,099

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, internally developed software, and property and equipment. Inventory and internally developed software were measured using a cost approach. Property and equipment were valued using a combination of the market and cost approaches.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Acquisitions (Continued)

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

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

We used the following methods to measure fair value of intangible assets:

Developed technology and customer relations were valued using the multi-period excess earnings method

Trademarks were valued using the relief from royalty method

Internally developed software was valued using the cost approach

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

We recognized a warranty liability of $0.3 million related to CDIC s products. We expect to incur the majority of these costs by the end of 2011. The potential undiscounted amount of all future payments that we could be required to make under the warranty arrangements is estimated to be $0.3 million. As of December 31, 2010, there has been no change since August 14, 2009, in the amount recognized for this liability or any change in the range of outcomes or assumptions used to develop the estimates.

We recognized a deferred tax asset of $5.4 million, which includes $3.9 million related to CDIC s federal net operating loss (NOL) carryforward. CDIC had federal NOL carryforwards of $52.6 million based on tax returns filed through November 30, 2008 which expire between 2010 and 2028. The NOL carryforward that will be available for utilization during this period is limited to $11.1 million, resulting from change in ownership limitations under Section 382 of the Internal Revenue Code. We recognized an additional $1.5 million deferred tax asset and a $4.6 million deferred tax liability related to differences in the book and tax bases of acquired assets and liabilities.

We assumed $5.6 million in long-term debt, of which $5.3 million was repaid immediately. As of December 31, 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.

LumenVu, Inc.

In July 2007, we acquired all of the outstanding stock of LumenVu, Inc. (LumenVu), a private development stage company that developed, in conjunction with a leading academic research institution, a patented technology to improve the accuracy of catheter placement. The technology was exclusively licensed to

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Acquisitions (Continued)

LumenVu by a leading academic research institution. We intend to integrate this technology in a new product line that can be sold along with existing product lines in certain clinical markets.

The results of LumenVu s operations were included in our consolidated financial statements since the date of the acquisition. The acquisition, which was an asset purchase, had a purchase price that consisted of cash consideration of $2.9 million, note receivable forgiveness of $0.1 million, assumed liabilities of $0.6 million, which were paid at closing, and contingent future cash payments up to $10.0 million, which had an estimated fair value of $4.0 million at the date of acquisition. The future cash payments are contingent upon the continued development of the product and recognizing revenue from the sale of products incorporating this technology. The liability for contingent consideration is accreted to other expense over the expected payment period.

During the fourth quarter of 2010, we determined that, based upon our projected product development and release dates, maximum liability for future contingent consideration would not be required. We determined the fair value of future contingent consideration was $2.2 million. Accordingly, we reduced the liability for contingent consideration by $4.0 million as well reduced the deferred tax liability by $2.3 million and intangible assets by $6.3 million.

During 2010, 2009 and 2008, we recorded $0.5 million, $1.0 million and $0.9 million, respectively, of accretion expense. The fair value of assets acquired determined as of July 2007 was $11.8. Based upon the fair value of future contingent consideration determined in fourth quarter of 2010, the fair value of the assets acquired was $5.5 million. This amount has been allocated to an intangible technology asset, which will be amortized over ten years commencing with sales of products incorporating this technology. No amortization expense has been recorded as no products using this technology are available for sale. The amortization of this intangible technology asset is not deductible for tax purposes accordingly we have recorded a deferred tax liability of $2.0 million. Additionally, we recorded a deferred tax asset associated with net operating losses of LumenVu of $0.2 million.

SonoMetric Health, Inc.

In May 2004, we acquired 100% of the outstanding common shares of SonoMetric Health, Inc. (SonoMetric). The results of SonoMetric s operations have been included in our consolidated financial statements since that date. We purchased all of SonoMetric s outstanding common shares for an immediate cash payment of $1.5 million, plus future cash payments of up to $4.5 million contingent upon the amount of revenue recognized from the sale of the purchased software over the five-year period following the closing date of the acquisition. We accrued contingent payments of $0.1 million and $0.4 million as of December 31, 2009 and 2008, respectively, as a result of revenue recognized on the sale of the software. These contingent payments, which were measured and required through April 2009, were recorded as goodwill. We made the final contingent payment in the first quarter of 2010.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Goodwill and other intangible assets

Goodwill and other intangible assets consisted of the following (in thousands):

	As of December 31,	
	2010	2009
Goodwill, at historical cost	$ 35,425	$ 3,902
Foreign exchange translation	2,361	
Goodwill, inclusive of foreign exchange	37,786	3,902
Identifiable intangible assets:		
Definite lived intangible assets, net of accumulated amortization of $8,328 and $3,041	46,891	23,486
Indefinite lived intangible assets	532	532
Total intangible assets	$ 47,423	$ 24,018

The goodwill associated with VisualSonics has been recorded in the functional currency of VisualSonics, which is the Canadian dollar. During 2010 the translated balance of Goodwill increased by $2.4 million as the Canadian dollar increased in value against the US dollar. As of December 31, 2010 definite lived intangible assets had a remaining weighted average useful life of 8.7 years. Amortization expense related to intangible assets was $5.3 million, $1.5 million and $0.2 million for the years ended December 31, 2010, 2009 and 2008. Amortization expense of intangible assets is estimated to be $7.4 million in 2011, $6.7 million in 2012, $6.2 million in 2013, and $5.6 million in 2014. During the fourth quarter of 2010, we completed our annual impairment assessments of our goodwill and indefinite-lived intangible assets and determined that they were not impaired. If there is impairment, these assets would be measured at fair value.

8. Hedging activities

We are exposed to foreign currency risk from both trade receivable balances denominated in a currency other than the local currency and intercompany receivable balances denominated in currencies other than US Dollar (USD) and from translation of our foreign subsidiaries operating results. We enter into foreign currency forward and option contracts to reduce the impact of fluctuations on earnings associated with foreign currency exchange rate changes. These foreign currencies include the Australian dollar, the British pound, the Canadian dollar, the European Union euro, and the Japanese yen. We use foreign exchange contracts to mitigate risk and do not intend to engage in speculative transactions. Currently our foreign exchange contracts do not qualify for derivative hedge accounting. We seek to manage the counterparty risk associated with engaging in foreign currency contracts by limiting transactions to counterparties with which we have established banking relationships

We use foreign currency forward contracts to hedge a substantial portion of our intercompany receivable balances denominated in currencies other than the USD. As of December 30, 2010, we had $41.8 million in notional amount of foreign currency contracts that expire through January 31, 2011. 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 December 31, 2010 was not material to our results of operations or our financial position.

We use foreign currency forward and option contracts to hedge the impact of currency fluctuations on the translation of the financial statements of our foreign operations. As of December 31, 2010, we had $8.4 million in notional amount of foreign currency contracts expiring at various dates through September 2011. The fair value of these contracts, which are Level 2 securities, as of December 31, 2010 was a liability of $0.4 million.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Hedging activities (Continued)

Fair value measurements of foreign currency forward and option contracts are as follows (in thousands):

	Fair Value Measurements at December 31, 2010		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Hedge contracts	$	$ (463)	$
Unamortized option contract premiums		62	
Total	$	$ (401)	$

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

	Year Ended December 31,		
	2010	2009	2008
Hedges of intercompany balances			
(Loss) gain on foreign currency hedges	$ (4,003)	$ (3,384)	$ 217
Gain (loss) on translation of intercompany receivables	1,511	3,047	(2,649)
Hedges of translation of foreign operations			
Loss on foreign currency hedges	(783)	(337)	
Loss related to hedge activities	$ (3,275)	$ (674)	$ (2,432)

9. Long-term debt

Effective January 1, 2009, we adopted new accounting guidance, which clarifies the accounting for convertible debt instruments that may be settled in cash (including partial cash settlement) upon conversion. The new accounting guidance requires bifurcation of a component of the conversion option, classification of that component in equity and the accretion of the resulting discount on the debt to be recognized as part of interest expense in our consolidated statement of income in a manner that reflects the issuer s nonconvertible debt borrowing rate when interest cost is recognized.

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

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Long-term debt (Continued)

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 December 31,	
	2010	2009
Equity component	$ 33,957	$ 33,957
Senior convertible debt:		
Outstanding	$ 114,745	$ 114,745
Debt discount	17,647	22,171
Senior convertible, net	$ 97,098	$ 92,574

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

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

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

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 $4.9 million, $5.0 million and $8.3 million for the years ended December 31, 2010, 2009 and 2008. Interest expense for the contractual coupon was $4.3 million, $4.9 million and $8.0 million for the years ended December 31, 2010, 2009 and 2008.

In 2009, we repurchased $30.0 million in principal amount of our Notes for $25.2 million. As a result of these repurchases, we recorded a gain of $1.1 million in other income, net of deferred financing costs of $0.5 million and costs to complete the repurchase transaction. We also partially unwound the associated convertible note hedges, which resulted in proceeds to us of approximately $1.6 million for the sale of call options, offset by $1.5 million we paid for the repurchase of warrants. Following the repurchases, unamortized debt issuance costs approximated $1.8 million. The remaining discount of $17.7 million will be amortized over 3.5 years.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Long-term debt (Continued)

Repurchases in 2009 also resulted in the reduction of the carrying value of the equity component by $3.5 million, the allocated amount from repurchases of our senior convertible debt, and $0.2 million from the write-off of the deferred tax asset related to debt issuance costs, offset by a $1.7 million reduction of the deferred tax liability related to the debt discount. These were noncash items from the repurchase transaction.

In 2008, we repurchased $80.3 million in principal amount of our senior convertible notes for $62.4 million. As a result of these repurchases, we recorded a gain, net of deferred financing costs and costs to complete the repurchase transaction, of $8.2 million in other income,. The payment received from partially unwinding the associated convertible note hedges resulted in proceeds to us of approximately $6.4 million, offset by $5.9 million we paid for the repurchase of warrants. The transaction also resulted in a write off of $1.5 million of debt issuance costs. Following the repurchases, debt issuance costs approximated $2.7 million. The net proceeds from the issuance of the Notes, net of issuance costs, the convertible note hedge transaction, and the warrant transaction were $208.5 million.

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

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

In connection with our purchase of CDIC, we acquired long-term debt. As of December 31, 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 senior convertible debt is measured for disclosure only at fair value using quoted market prices (Level 1). As of December 31, 2010 and 2009, the fair value of our senior convertible debt was $126.0 million and $111.3 million.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Shareholders equity

Stock compensation plans

At December 31, 2010, we had six stock-based employee compensation plans: the 1998 Nonofficer Employee Stock Option Plan (1998 NOE Plan), the 1998 Stock Option Plan (1998 Plan), the Nonemployee Director Stock Option Plan (Director Plan), the Amended and Restated 2005 Stock Incentive Plan (2005 Plan), the 2005 Employee Stock Purchase Plan (2005 ESPP Plan) and the 2010 Equity Incentive Plan (VisualSonics Plan).

Total stock-based compensation expense recognized in our consolidated statements of operations consisted of the following (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Stock options	$ 1,210	$ 972	$ 1,978
Restricted stock units	5,167	5,362	6,105
Employee stock purchase plan		218	626
Total stock-based compensation	$ 6,377	$ 6,552	$ 8,709

The related deferred tax benefit was $2.3 million, $2.4 million and $3.0 million for the years ended December 31, 2010, 2009 and 2008.

As part of the acquisition of VisualSonics, we assumed options to purchase common shares and restricted stock units granted by VisualSonics under the VisualSonics Plan prior to the acquisition. The number of shares of our common stock underlying the assumed options is 287,750, and the exercise prices for the assumed options are equal to the fair market value of VisualSonics common shares at the date of grant, adjusted upon acquisition pursuant to an agreed upon exchange ratio that reflected the fair market value of our common stock on the date of acquisition and the consideration attributable to each VisualSonics common share in the acquisition. The assumed stock options will vest and become exercisable with respect to 25% of each grant beginning on June 30, 2011 and on each of the three anniversaries thereafter, and have a seven year term from the grant date. The number of shares of our common stock underlying the assumed RSUs is 345,689. Most of the assumed restricted stock units will vest with respect to one-third (1/3) of each grant beginning on June 30, 2013 and on each of the two anniversaries thereafter; however, certain assumed restricted stock unit grants will vest entirely on June 30, 2013. No shares are available for grant under the VisualSonics Plan.

Under the 1998 NOE Plan, 1998 Plan, 2005 Plan, and option grants outside our stock option plans, as of December 31, 2010, 7,240,000 total shares of common stock were authorized primarily for issuance upon exercise of stock options and release of restricted stock units at prices equal to the fair market value of our common shares at the date of grant. As of December 31, 2010, 2,317,045 of those shares granted under the plans were still outstanding, and 386,392 shares were still available for grant under these stock option plans. In most cases, stock options vest 25% each year over a four year vesting period. Certain stock options vest 25% after one year of employment and then monthly over the next three years, and certain grants made to employees after their first year of employment vest monthly over four years. All options have either a seven or ten year term from the grant date.

Under the Director Plan, as of December 31, 2004, 125,000 shares of common stock were authorized for issuance of stock options at prices equal to the fair market value of our common shares at the date of grant. At December 31, 2005, there were no longer shares available for grant under this Plan. Stock options are exercisable

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Shareholders equity (Continued)

and vest in full one year following their grant date provided the optionee has continued to serve as our director. Each option expires on the earlier of ten years from the grant date or 90 days following the termination of a director s service as our director.

The 2005 ESPP Plan, which qualifies under Section 423 of the Internal Revenue Code, permits all U.S. based employees to purchase shares of our common stock. Participating employees may purchase common stock through payroll deductions at the end of each participation period at a purchase price equal to 85% of the lower of the fair market value of the common stock at the beginning or the end of the participation period. The 2005 ESPP was discontinued in 2009 and on through 2010. As of December 31, 2010 1,000,000 shares of common stock were authorized for issuance under the 2005 ESPP Plan. During the years ended December 31, 2009 and 2008, 66,498 and 95,248 shares of common stock were issued under this plan, respectively.

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

The fair value for stock option awards and shares associated with the employee stock purchase plan was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	Stock Options Year Ended December 31,			ESPP Year Ended December 31,		
	2010	2009	2008	2010	2009	2008
Expected term (in years)		5.0	5.0		0.5	0.5
Expected stock price volatility		34%	34%		46%	41%
Risk-free interest rate		2.3%	2.7%		1.1%	1.5%
Expected dividend yield		0.0%	0.0%		0.0%	0.0%
Weighted average fair value of options granted		$ 7.31	$ 7.55		$ 5.67	$ 6.92

The expected term of the options and ESPP represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. Expected stock price volatility is based on historical volatility of our stock over the historical period commensurate with the expected term assumptions. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant with an equivalent remaining term. We have not paid dividends in the past and do not plan to pay any dividends in the near future.

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SONOSITE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Shareholders equity (Continued)

Summary of stock option activity

The following table presents summary stock option activity for the year ended December 31, 2010 (shares presented in thousands):

	Shares	Weighted average exercise price	Weighted average remaining contractual life	Aggregate intrinsic value (in thousands)
Outstanding, beginning of year	1,664	$ 24.34		
Granted				
Assumed VisualSonics Plan	288	$ 27.45		
Exercised	(290)	$ 18.14		
Forfeited	(55)	$ 23.27		
Expired	(109)	$ 30.19		
Outstanding, end of year	1,498	$ 25.76	4.00	$ 11,505
Exercisable, end of year	954	$ 27.25	2.97	$ 6,727

The aggregate intrinsic value in the table above is based on our stock price of $31.92 on December 31, 2010, which would have been received by the optionees, without reduction for applicable income taxes, had all options been exercised on that date. As of December 31, 2010, total unrecognized stock-based compensation expense related to nonvested stock options was $3.0 million, which is expected to be recognized over a weighted average period of approximately 3.35 years. During the years ended December 31, 2010, 2009 and 2008, the total intrinsic value of stock options exercised was $3.3 million, $0.1 million and $3.0 million, respectively.

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

The following is a summary of stock options outstanding as of December 31, 2010 (shares presented in thousands):

	Options outstanding			Options exercisable	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
$11.34 $16.32	91	1.77	$ 15.67	91	$ 15.67
$16.44 $16.44	350	4.79	$ 16.44	169	$ 16.44
$17.26 $27.00	315	3.17	$ 22.02	243	$ 21.89
$27.45 $28.24					