SONOSITE INC
Form 10-Q
November 09, 2005

Table of Contents

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

X **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

For the quarterly period ended September 30, 2005

OR

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

Commission file number 0-23791

SONOSITE, INC.

(Exact name of registrant as specified in its charter)

Washington	**91-1405022**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification Number)**
21919 30th Drive SE, Bothell, WA	**98021-3904**
(Address of Principal Executive Offices)	**(Zip Code)**

(425) 951-1200
(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes X No

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

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

Common Stock, $0.01 par value	**15,776,269**
(Class)	**(Outstanding as of November 3–, 2005)**

Table of Contents

SonoSite, Inc.

Quarterly Report on Form 10-Q
For the Quarter Ended September 30, 2005

Table of Contents

Table of Contents

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

SonoSite, Inc.

Condensed Consolidated Balance Sheets
(unaudited)

(In thousands, except share data) Assets	September 30, 2005	December 31, 2004
Current assets:		
Cash and cash equivalents	$ 21,224	$ 17,272
Short-term investment securities	19,944	14,319
Accounts receivable, less allowances of $927 and $942	34,114	33,586
Inventories	23,583	17,990
Deferred income taxes	5,532	3,596

Prepaid expenses and other current assets	2,870	2,476
Total current assets	107,267	89,239
Property and equipment, net	7,654	7,632
Investment securities	22,869	32,490
Deferred income taxes	21,332	21,189
Goodwill	1,008	972
Identifiable intangible assets, net	1,929	1,768
Other assets	1,388	1,802
Total assets	$ 163,447	$ 155,092
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 4,569	$ 6,360
Accrued expenses	10,318	10,747
Deferred revenue	4,865	4,522
Total current liabilities	19,752	21,629
Deferred rent	288	228
Total liabilities	20,040	21,857
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, $1.00 par value		
Authorized shares--6,000,000		
Issued and outstanding shares--none	--	--
Common stock, $.01 par value		
Authorized shares--50,000,000		
Issued and outstanding shares:		
As of September 30, 2005--15,747,167		
As of December 31, 2004--15,250,783	157	152
Additional paid-in-capital	208,614	196,318
Deferred stock compensation	(1,809)	--
Accumulated deficit	(64,325)	(64,444)
Accumulated other comprehensive income	770	1,209
Total shareholders' equity	143,407	133,235
Total liabilities and shareholders' equity	$ 163,447	$ 155,092

See accompanying notes to condensed consolidated financial statements.

Table of Contents

SonoSite, Inc.

Condensed Consolidated Statements of Operations
(unaudited)

(In thousands, except loss per share)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Revenue	$ 34,809	$ 29,124	$ 102,289	$ 78,714
Cost of revenue	10,297	9,601	30,784	26,632
Gross margin	24,512	19,523	71,505	52,082
Operating expenses:				
Research and development	3,803	2,943	11,017	9,063
Sales and marketing	15,464	12,652	50,277	36,400
General and administrative	3,175	2,686	9,656	7,065
Total operating expenses	22,442	18,281	70,950	52,528
Other income (expense):				
Interest income	459	241	1,147	680
Interest expense	--	--	--	(2)
Other	(5)	101	(795)	(112)
Total other income (expense)	454	342	352	566
Income before income taxes	2,524	1,584	907	120
Provision for income taxes	1,078	169	788	169
Net income (loss)	$ 1,446	$ 1,415	$ 119	$ (49)
Basic net income (loss) per share	$ 0.09	$ 0.10	$ 0.01	$ (0.00)
Diluted net income (loss) per share	$ 0.09	$ 0.09	$ 0.01	$ (0.00)
Weighted average common and potential common shares used in computing:				
Basic net income (loss) per share	15,630	14,837	15,461	14,742
Diluted net income (loss) per share	16,285	15,738	16,100	14,742

See accompanying notes to condensed consolidated financial statements.

Table of Contents

SonoSite, Inc.

Condensed Consolidated Statements of Cash Flows
(unaudited)

(In thousands)	Nine Months Ended September 30,	
	2005	2004

Operating activities:		
Net income (loss)	$ 119	$ (49)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,355	2,200
Equity in losses of affiliates	49	7
Net loss (gain) on investments	20	(39)
Amortization of premiums on investment securities	379	548
Stock-based compensation	65	76
Deferred income taxes	795	--
Changes in operating assets and liabilities:		
Accounts receivable	(1,714)	860
Inventories	(5,966)	(532)
Prepaid expenses and other assets	(144)	(2,474)
Accounts payable	(1,749)	2,177
Accrued expenses	(210)	2,485
Deferred liabilities	458	40
Net cash provided by (used in) operating activities	(5,543)	5,299
Investing activities:		
Purchases of investment securities	(33,321)	(25,868)
Proceeds from sales/maturities of investment securities	36,825	23,772
Purchases of property and equipment	(2,126)	(3,652)
Purchase of SonoMetric Health, Inc.	--	(2,070)
Purchase of SonoSite China Medical Ltd.	(402)	--
Net cash provided by (used in) investing activities	976	(7,818)
Financing activities:		
Exercise of stock options	7,461	3,693
Repayment of long-term obligations	--	(88)
Net cash provided by financing activities	7,461	3,605
Effect of exchange rate changes on cash and cash equivalents	1,058	(249)
Net change in cash and cash equivalents	3,952	837
Cash and cash equivalents at beginning of period	17,272	13,683
Cash and cash equivalents at end of period	$ 21,224	$ 14,520
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 276	$ --

See accompanying notes to condensed consolidated financial statements.

Table of Contents

SonoSite, Inc.

Notes to Condensed Consolidated Financial Statements
(unaudited)

Interim Financial Information

Basis of Presentation

The information contained herein has been prepared in accordance with instructions for Form 10-Q and Article 10 of Regulation S-X. The information furnished reflects, in the opinion of SonoSite, Inc. management, all adjustments necessary (which are of a normal and recurring nature) for a fair presentation of the results for the interim periods presented. The results of operations for the three and nine months ended September 30, 2005 are not necessarily indicative of expected results for the entire year ending December 31, 2005 or for any other fiscal period. These financial statements do not include all disclosures required by generally accepted accounting principles. For a presentation including all disclosures required by generally accepted accounting principles, these financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2004, included in our Annual Report on Form 10-K.

Certain prior year amounts have been reclassified to conform to current period presentation.

Stock-based compensation

At September 30, 2005, we had seven stock-based employee compensation plans. We account for those plans under the intrinsic value method in accordance with the provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations. Accordingly, compensation cost related to stock option grants to employees has been recognized only to the extent that the fair market value of the stock exceeds the exercise price of the stock option at the date of the grant. We recognize compensation expense for restricted stock unit grants over the applicable vesting period.

The following table illustrates the effect on net income (loss) and net income (loss) per share if we had applied the fair value recognition provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), to stock-based employee compensation (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss), as reported	$ 1,446	$ 1,415	$ 119	$ (49)
Add: Stock-based employee compensation expense, as reported, net of related tax effects	76	--	110	--
Less: Stock-based employee compensation expense determined under fair value based method, net of related tax effects	(804)	(1,068)	(2,207)	(3,559)
Pro forma net income (loss)	$ 718	$ 347	$ (1,978)	$ (3,608)
Basic net income (loss) per share:				
As reported	$ 0.09	$ 0.10	$ 0.01	$ (0.00)
Pro forma	$ 0.05	$ 0.02	$ (0.13)	$ (0.24)
Diluted net income (loss) per share:				
As reported	$ 0.09	$ 0.09	$ 0.01	$ (0.00)
Pro forma	$ 0.04	$ 0.02	$ (0.13)	$ (0.24)

For the nine months ended September 30, 2005 and 2004, we excluded equity instruments from the calculation of diluted pro forma net loss per share because the effect of including such instruments is antidilutive.

We account for non-employee stock-based compensation in accordance with SFAS 123 and FASB Emerging Issues Task Force ("EITF"), Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services."

Table of Contents

Cash and cash equivalents

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

Investment securities

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

A decline in market value of any available-for-sale security below cost that is determined to be other than temporary results in a revaluation of its carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Interest income is recognized when earned.

Accounts receivable

In the ordinary course of business, we grant credit to a broad customer base. Of the accounts receivable balance at September 30, 2005, 44% and 56% were receivable from domestic and international parties, prior to any allowances. The same percentages as of December 31, 2004 were 39% and 61% prior to any allowances.

For the three months ended September 30, 2005, revenue was 59% domestic and 41% international, compared to 56% domestic and 44% international for the three months ended September 30, 2004. For the nine months ended September 30, 2005, revenue was 52% domestic and 48% international, compared to 53% domestic and 47% international for the nine months ended September 30, 2004.

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

Fair value of financial instruments

The carrying value of our financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and certain long-term other assets, approximates fair value. Cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to their short-term nature. Other long-term assets approximate fair value as interest rates on these items approximate market. Our investment securities, which consist of high-grade debt securities, are carried at fair value. We may incur unrealized losses due to changes in market value attributable to changes in interest rates and not credit quality. We have the ability and intent to hold our investments until a recovery of fair value, which may be maturity. Accordingly, we view any unrealized losses as temporary at September 30, 2005.

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 recognize all derivative financial instruments (foreign currency forward contracts) in accordance with SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities," as amended. Changes in the fair value of derivative instruments are recorded in earnings unless hedge accounting criteria are met. For derivative instruments designated as fair value hedges, the changes in fair value of both the derivative instrument and the hedged item are recorded in earnings. For derivative instruments designed as cash flow and net investment hedges, the effective portions of changes in the fair value of the derivative are recorded in other comprehensive income. The ineffective portions are recognized in earnings. As of September 30, 2005, we had $28.9 million in foreign currency forward contracts that expire on December 30, 2005.

Table of Contents

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 refurbished products held either as saleable inventory or as demonstration product. If market conditions are less favorable than those projected by management, additional downward inventory cost adjustments may be required.

Inventories consisted of the following, net of valuation adjustments (in thousands):

	As of	
	September 30, 2005	**December 31, 2004**
Raw material	$ 10,586	$ 5,965
Work-in-process	104	--
Demonstration inventory	5,108	4,112
Finished goods	7,785	7,913
Total	$ 23,583	$ 17,990

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	3-5 years
Furniture and fixtures	5 years
Leasehold improvements	Lesser of estimated useful life or remaining lease term

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

The carrying value of long-lived assets is evaluated for impairment when events or changes in circumstances occur that may indicate the carrying amount of the asset may not be recoverable. For definite-lived intangible assets, we evaluate the carrying value of the assets by comparing the estimated future undiscounted cash flows generated from the use of the asset and its eventual disposition with the asset's reported net book value. For indefinite-lived intangible assets, we evaluate the carrying value of the asset by comparing its estimated fair market value with its reported net book value.

Table of Contents

Warranty liability

Our typical warranty period is one year except for the recently introduced SonoSite MicroMaxx (TM) system ("MicroMaxx system"), which has, with certain exceptions, a five-year warranty period. The warranty is included with the original purchase. The warranty liability is summarized as follows (in thousands):

	Balance at beginning of period	Charged to cost of revenue	Applied to liability	Balance at end of period
Three months ended September 30, 2005	$ 573	$ 365	$ (141)	$ 797
Three months ended September 30, 2004	$ 431	$ 155	$ (155)	$ 431
Nine months ended September 30, 2005	$ 561	$ 678	$ (442)	$ 797
Nine months ended September 30, 2004	$ 381	$ 452	$ (402)	$ 431

Concentration of credit and supply risk

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

We depend on some single-source suppliers to provide highly specialized parts and other components, 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.

Comprehensive income (loss)

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss)	$ 1,446	$ 1,415	$ 119	$ (49)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(44)	81	(381)	(279)
Unrealized holding gains (losses) arising during the period, net of tax	(92)	87	(71)	(206)
Less reclassification adjustment for losses (gains) included in net income (loss), net of tax	3	3	13	(39)
Comprehensive income (loss)	$ 1,313	$ 1,586	$ (320)	$ (573)

Net income (loss) per share

Basic net income (loss) per share is based on the weighted average of all common shares issued and outstanding, and is calculated by dividing net income (loss) by the weighted average shares outstanding during the period. Diluted net income (loss) per share is calculated by dividing net income (loss) by the weighted average number of common shares used in the basic net income (loss) per share calculation plus the number of common shares that would be issued assuming exercise of all potentially dilutive common shares outstanding using the treasury stock method.

Table of Contents

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss)	$ 1,446	$ 1,415	$ 119	$ (49)
Weighted average common shares outstanding used in computing basic net income (loss) per share	15,630	14,837	15,461	14,742
Effect of dilutive stock options and restricted stock units	655	901	639	--
Weighted average common shares outstanding used in computing diluted net income (loss) per share	16,285	15,738	16,100	14,742

We exclude equity instruments from the calculation of diluted weighted average shares outstanding if the effect of including such instruments is antidilutive to net income (loss) per share. Accordingly, certain employee stock options and restricted stock units totaling 10,000 and 374,000 shares for the three months ended September 30, 2005 and 2004 and 148,000 and 2,686,000 shares for the nine months ended September 30, 2005 and 2004 have been excluded from the calculation of diluted weighted average shares.

Income taxes

The income tax provision for the three and nine month periods ended September 30, 2005 was computed in accordance withAPB Opinion No. 28, "Interim Financial Reporting," and FASB Interpretation No. 18, "Accounting for Income Taxes in Interim Periods," and was based on projections of total year pre-tax income and the projected total year tax provision computed in accordance with SFAS No. 109, "Accounting for Income Taxes." We are required to estimate the effective income tax rate in each of the jurisdictions in which we operate. Deferred income taxes are provided based on the estimated future tax effects of temporary differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards arising since our inception. Deferred tax assets and liabilities are measured using enacted tax rates that are expected to apply to taxable income in the years in which those temporary differences and carryforwards are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is established when necessary to reduce deferred tax assets to the amount, if any, expected to be realized.

Foreign currency translation

The functional currencies of our international subsidiaries consisting primarily of the British pound, the European Union euro and the Japanese yen, are the local currency of the country in which the subsidiary is located. Assets and liabilities denominated in foreign currencies are translated at the exchange rate on the balance sheet date. Revenues, costs and expenses of international operations are translated at average rates of exchange prevailing during the period. Net realized and unrealized gains on currency transactions were $9,000 and $116,000 for the three months ended September 30, 2005 and 2004, compared with losses of $806,000 and $70,000 for the nine months ended September 30, 2005 and 2004, and are included in other income (expense).

Indemnification Obligations and Guarantees

We apply the disclosure provisions of FASB Interpretation No. ("FIN") 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45") to our agreements that contain guarantee or indemnification clauses. We provide (i) indemnifications of varying scope and size to our customers and distributors against claims of intellectual property infringement made by third parties arising from the use of our products; (ii) indemnifications of varying scope and size to our customers against third party claims arising as a result of defects in our products; (iii) indemnifications of varying scope and size to consultants against third party claims arising from the services they provide to us; and (iv) guarantees to support obligations of some of our subsidiaries such as lease payments. These indemnifications and guarantees give rise only to the disclosure provisions of FIN 45.

Table of Contents

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

Litigation

On July 24, 2001, Neutrino Development Corporation ("Neutrino") filed a complaint against us in U.S. District Court, Southern District of Texas, Houston Division, alleging infringement of U.S. Patent 6,221,021, ("the '021 patent"), by SonoSite as a result of our use, sale and manufacture of the SonoSite 180, SonoSite 180PLUS, SonoHeart and SonoHeart Plus devices. Subsequently, the SonoHeart ELITE, iLook, TITAN and MicroMaxx systems were also added to the lawsuit. The complaint asserts claims for preliminary and permanent injunctive relief enjoining all alleged acts of infringement, compensatory and enhanced damages, attorney's fees and costs, and pre- and post-judgment interest. On August 14, 2001, we filed an answer asserting affirmative defenses of non-infringement and patent invalidity, and included a counterclaim seeking a declaratory judgment of non-infringement and invalidity regarding Neutrino's patent. On October 4, 2001, the court denied a request by Neutrino for preliminary injunctive relief to prevent us from manufacturing and selling our products pending the ultimate disposition of the litigation. On February 20, 2002, in what is known as a "Markman" hearing, the parties presented their arguments regarding the proper construction of Neutrino's patent claims.

On August 20, 2003, the U.S. District Court in the Southern District of Texas issued a decision interpreting certain terms used in the '021 patent. This decision does not discuss whether the patent is valid or whether the patent would apply to any of our products. In the order, the court, in resolving disputed terms in the Markman hearing, adopted our construction of the term "a portable body designed to be hand held", and adopted Neutrino's construction of the terms "the moveably connected transducer mounting assembly" and "ultrasound emitter". The court denied our motion for summary judgment. We subsequently filed a new summary judgment motion using the court's construction of the claim language that the '021 patent is invalid based on prior art. Neutrino filed a summary judgment motion based on its allegations of infringement.

On September 30, 2004, the Texas court issued its rulings on the summary judgment motions. First, the court denied our motion for summary judgment based on invalidity, finding that there are issues of fact in dispute that must be resolved by a jury at trial. Second, the court granted Neutrino's motion for summary judgment of infringement, finding that the SonoSite products infringe the '021 patent as the court has construed the claims in the Markman hearing. As a result, the court ordered us and Neutrino to enter into mediation, which was required to be completed by January 31, 2005. Mediation was unsuccessful and the court set a jury trial date for the fall of 2005. However, as of the date of this filing, no specific trial date has yet been set. The parties have completed the filing of pretrial motions and expert reports, discovery, and depositions. Prior to the start of trial, the court must rule on numerous motions filed by the parties that are pending before it.

Neutrino also filed suit in the Middle District of Florida on August 19, 2003 against a former SonoSite distributor alleging that the sale of our products by such distributor infringes the '021 patent. SonoSite assumed the defense of the distributor in accordance with our contractual obligations under the distribution agreement. In December 2004, Neutrino agreed to dismissal of all claims in this suit in return for SonoSite's consent to Neutrino's filing of a Second Amended Complaint in the Texas proceeding to add the SonoSite TITAN, SonoHeart ELITE and iLook systems to the Texas suit. Neutrino had also previously filed a similar suit in the Middle District of Tennessee against another medical device distributor for selling a SonoSite product. The Tennessee case was dismissed based on a final judgment and permanent injunction filed a month after the case was filed. The Florida action and the Tennessee judgment have no effect on the Texas proceedings.

We believe that we have good and sufficient defenses to the claims of patent infringement asserted against us by Neutrino and we are vigorously defending ourselves in these matters. If we are not successful in our defense of these claims, we could be forced to pay damages related to past product sales, modify or discontinue selling our products or may enter into royalty or licensing agreements for future product sales, which may not be available on terms acceptable to us, if at all, and which could adversely affect our financial condition, results of operations and cash flow. Sales of the allegedly infringing products represented the majority of our revenue for the nine-month periods ended September 30, 2005 and 2004.

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

Table of Contents

Acquisition

As of March 31, 2005, we had a 30% ownership interest in SonoSite China Medical Ltd. ("SCM"), a joint venture in China to market our products there. In April 2005, we acquired the remaining 70% of SCM for approximately $402,000. The results of SCM's operations have been included in our consolidated financial statements since that date. The estimated fair value of the assets acquired and liabilities assumed at the date of acquisition was approximately $43,000 for net tangible assets and $359,000 for indefinite-lived intangible assets. The indefinite-lived intangible assets are comprised primarily of reacquired distribution rights. We have determined that they have indefinite lives because there are no legal, regulatory or contractual provisions that may limit their useful lives.

Segment reporting

We currently have one reportable segment. We market our products in the United States and internationally through our direct sales force and our indirect distribution channels. Our chief operating decision maker evaluates resource allocation decisions and our performance based upon revenue recorded in geographic regions and does not receive financial information about expense allocation on a disaggregated basis. Geographic regions are determined by the shipping destination. Revenue by geographic location is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
United States	$ 20,390	$ 16,236	$ 53,282	$ 41,906
Europe, Africa and the Middle East	7,672	6,999	28,972	23,743
Japan	3,103	3,105	9,369	6,328
Canada, South and Latin America	1,754	1,233	7,233	2,925
Asia Pacific	1,890	1,551	3,433	3,812
Total revenue	$ 34,809	$ 29,124	$ 102,289	$ 78,714

Recent accounting pronouncements

In November 2004, the FASB issued SFAS No. 151 "Inventory Costs -- An Amendment of ARB No. 43, Chapter 4" ("SFAS 151"), which clarifies that abnormal amounts of idle facility expense, freight, handling costs and spoilage should be expensed as incurred and not included in overhead. Further, SFAS 151 requires that allocation of fixed and production facilities overheads to conversion costs should be based on normal capacity of the production facilities. The provisions in this statement are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not believe that the adoption of SFAS 151 will have a significant effect on our future consolidated financial statements.

Table of Contents

In November 2004, the FASB issued SFAS No. 153 "Exchanges of Nonmonetary Assets -- An Amendment of APB Opinion No. 29" ("SFAS 153"). The provisions of this statement are effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. This statement eliminates the exception to fair value for exchanges of similar productive assets and replaces it with a general exception for exchange transactions that do not have commercial substance -- that is, transactions that are not expected to result in significant changes in the cash flows of the reporting entity. The adoption of SFAS 153 did not have a significant effect on our consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123R, "Share-based Payment" ("SFAS 123R"). SFAS 123R revises SFAS 123 and supersedes APB 25. SFAS 123R applies to transactions in which an entity exchanges its equity instruments for goods or services and also applies to liabilities an entity may incur for goods or services that are based on the fair value of those equity instruments. Under SFAS 123R, we will be required to follow a fair value approach using an option-pricing model, such as the Black-Scholes option valuation model, at the grant

date of a stock-based award. The compensation calculated under the fair value method will then be recognized over the respective vesting period of the stock-based award. We will adopt the provisions of SFAS 123R during the first quarter of 2006 and are still in the process of estimating the impact upon adoption, but it is expected to have a material impact on our results of operations. Also, SFAS 123R will require us to reflect the tax savings resulting from tax deductions in excess of expense reflected in our financial statements as a financing cash flow, which may have a material impact on our future reported cash flows from operating activities.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections, A Replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS 154"). SFAS 154 requires retrospective application to prior periods' financial statements for changes in accounting principles, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in non-discretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement is issued. We are required to adopt the provisions of SFAS 154, as applicable, beginning in fiscal 2006.

In March 2005, the FASB issued FIN No. 47, "Accounting for Conditional Asset Retirement Obligations, An Interpretation of FASB Statement No. 143," ("FIN 47") which requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. We are required to adopt FIN 47 by the end of 2005. We do not expect that the adoption of FIN 47 will have significant effect on our future consolidated financial statements.

In November 2005, the FASB issued FASB Staff Position FAS 115-1 and FAS 124-1, " The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("FSP"). The FSP addresses determining when an investment is considered impaired, whether that impairment is other than temporary, and measuring an impairment loss. The FSP also addresses the accounting after an entity recognizes an other-than-temporary impairment, and requires certain disclosures about unrealized losses that the entity did not recognize as other-than-temporary impairments. We are required to adopt the FSP at the beginning of fiscal 2006 and do not believe the adoption will have a significant effect on our future consolidated financial statements.

In June 2005, the FASB issued FSP FAS 143-1, "Accounting for Electronic Equipment Waste Obligations" ("FSP 143-1"), which provides guidance on the accounting for obligations associated with the Directive on Waste Electrical and Electronic Equipment (the "Directive"), which was adopted by the European Union. Under the Directive, the waste management obligation for historical equipment (products put on the market on or prior to August 13, 2005) remains with the commercial user until the equipment is replaced. FSP 143-1 is required to be applied to the later of the first reporting period ending after June 8, 2005 or the date of the Directive's adoption into law by the applicable European Union member countries in which we have significant operations. We are evaluating the effect that the adoption of FSP 143-1 will have on our consolidated results of operations and financial condition. Such effects will depend on the respective laws adopted by the European Union member countries.

Table of Contents

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

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

- 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 revenue, and about the expected composition of our revenue;
- statements about our future capital requirements and the sufficiency of our cash, cash equivalents and investments 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, Current Reports on Form 8-K and Annual Reports on Form 10-K. Also note that we provide a cautionary discussion of risks, uncertainties and possibly inaccurate assumptions relevant to our business under the caption "Important Factors That May Affect Our Business, Our Results of Operations and Our Stock Price" in this report. These are risks that could cause our actual results to differ materially from those anticipated in our forward-looking statements or from our expected or historical results. Other factors besides the risks, uncertainties and possibly inaccurate assumptions described in this report could also affect actual results.

Overview

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

The size and complexity of traditional cart-based ultrasound systems typically require a physician or highly trained clinician to perform the examination in a centralized imaging department, such as a hospital's radiology department. By providing ultrasound at the primary point-of-care, our easy-to-use systems can eliminate delays associated with the referral process and enable physicians to use ultrasound more frequently and in a wider variety of clinical settings. This increased accessibility is changing clinical practice, improving patient care and has the potential to reduce cost through earlier and more rapid diagnosis of diseases and conditions.

Our products are used for imaging in medical specialties, such as radiology, cardiology, obstetrics and gynecology, emergency medicine, surgery, critical care, internal medicine and vascular medicine. In addition, the U.S. Military has successfully deployed our systems in both traditional hospital settings and into field hospitals and forward surgical teams. We began shipping our first products in September 1999 and today have an installed based of more than 20,000 systems worldwide.

Table of Contents

Our first generation of products includes the 180 and iLook series. The SonoSite 180PLUS system is designed for general ultrasound imaging and the SonoHeart ELITE is specifically configured for cardiovascular applications. The iLook 25 imaging tool is designed to provide visual guidance for physicians and nurses while performing vascular access procedures and the iLook 15 imaging tool is designed to provide imaging of the chest and abdomen. Our second generation product, the TITAN system, began shipping in June 2003. This high performance system has both general imaging and cardiology capabilities. On April 18, 2005, we introduced our newest product, the MicroMaxx system. The MicroMaxx system is our third generation product based on our proprietary Application Specific Integrated Circuit ("ASIC") technology for high-resolution ultrasound imaging. Our first shipments of the MicroMaxx system occurred in mid-June 2005.

We were formerly a division of ATL Ultrasound, Inc., ("ATL"). On April 6, 1998, we were spun-off as an independent, publicly owned Washington corporation. ATL retained no ownership in us following the spin-off. We entered into a technology transfer and license agreement with ATL pursuant to which 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.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with instructions for Form 10-Q and Article 10 of Regulation S-X. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to product returns, bad debts, inventories, goodwill, intangible assets, warranty obligations, income taxes, and stock-based compensation. 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.

Our critical accounting policies and estimates are as follows:

Accounts receivable. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We determine the adequacy of this allowance by regularly reviewing the aging of our accounts receivable and evaluating individual customer receivables, considering customers' financial condition, historical experience, credit history and current economic condition. Losses can be difficult to anticipate. An increase in losses beyond those expected by management would reduce earnings when they become probable or as the estimated loss increases.

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

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

Our sales arrangements may contain multiple elements, which include hardware and software products. Revenue from the sale of software, software-related elements, and hardware when the software elements are more than incidental to the product as a whole, is recognized in accordance with SOP 97-2, "Software Revenue Recognition," as amended. We have vendor specific objective evidence, ("VSOE") of fair value for our products. Accordingly, for transactions that have undelivered elements for which we have VSOE of the elements, revenue equal to the total fair value of the undelivered elements is deferred and is not recognized until the element is delivered to the customer.

Table of Contents

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 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 write down the cost of our inventories.

Goodwill. Goodwill represents the excess of cost over the estimated fair value of net assets acquired in connection with our acquisition of SonoMetric Health, Inc. ("SonoMetric"). We test goodwill for impairment on an annual basis, or more frequently if circumstances dictate, for each reporting unit identified for purposes of accounting for goodwill. A reporting unit is an operating segment or one level below an operating segment (referred to as a component). A component is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component. Discrete financial information is available only for SonoSite as a whole; there is no discrete financial information available for SonoMetric because it was incorporated into SonoSite immediately after acquisition. Therefore, SonoSite is the reporting unit to which goodwill resulting from the SonoMetric acquisition is assigned.

Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. Changes in these estimates and assumptions could potentially result in recognition of an impairment of goodwill, which would be reflected as a loss on our statement of operations and as a reduction in the carrying value of goodwill.

Intangible Assets. Our intangible assets are comprised primarily of acquired technology and non-compete agreements related to the SonoMetric acquisition and reacquired distribution rights related to the SCM acquisition. We use our judgment to estimate the fair value of each of these intangible assets. Our judgment about fair value is based on our expectation of future cash flows and an appropriate discount rate. We also use our judgment to estimate the useful lives of each intangible asset.

With respect to definite lived intangible assets, we evaluate the remaining useful lives annually. Indefinite-lived intangible assets are tested for impairment annually, or more frequently if circumstances dictate. If we conclude that any indefinite-lived intangible asset is impaired, we would record this as a loss on our statement of operations and as a reduction to the intangible asset.

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 experience and management's judgment. We have limited history with some of our products. In addition, we provide, with certain exceptions, a five-year warranty with the MicroMaxx system, which we began shipping in mid-June 2005. Given the length of the warranty period, the warranty liability for the MicroMaxx system 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 MicroMaxx system compared with our other systems and the long-term repair rates of those other systems, we believe that we can reasonably estimate the amount of the warranty liability for this product. We expect our warranty liability and expense to increase significantly due to the five-year warranty offered with this product. Should actual failure rates and 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. As part of the process of preparing our condensed consolidated financial statements, we are required to determine our income taxes. This process involves estimating our annual effective tax rate by jurisdiction and the nature and measurements of temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences, and our net operating loss 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 do not meet the test that recovery is "more likely than not", we establish a valuation allowance. To the extent that we establish a valuation allowance or change this allowance in a period, we adjust our tax provision or tax benefit in the statement of operations. We use our judgment to determine our provision or benefit for income taxes, and any valuation allowance recorded against our deferred tax assets.

Table of Contents

We have accumulated U.S. federal income tax net operating loss ("NOL") carryforwards, foreign NOL carryforwards and research and experimentation tax credit carryforwards. Deferred tax assets were recognized on our balance sheet in the fourth quarter of 2004. Prior to this time, we provided a full valuation allowance against our deferred tax assets. The deferred tax assets primarily represent the income tax benefit of U.S. NOL's we have incurred. As required by SFAS No. 109, "Accounting for Income Taxes," ("SFAS 109") we did not recognize any tax assets on our balance sheet until it was "more likely than not" that the tax assets related to our U.S. operations would be realized. We have retained a valuation allowance against our deferred tax asset resulting from our international operations. Based upon a review of historical operating performance and our expectation that we will generate sustainable U.S. profitability for the foreseeable future, we believe it is more likely than not that the U.S. deferred tax assets will be fully realized. We will reevaluate our ability to utilize our NOL and tax credit carryforwards in future periods and, in compliance with SFAS 109, record any resulting adjustments that may be required to deferred income tax expense. In addition, we will reduce the deferred income tax asset for the benefits of NOL and tax credit carryforwards actually used in future quarters. The future impact on net income may therefore be positive or negative, depending on the net result of such adjustments and charges.

Stock-Based Compensation. We have elected to measure our stock-based compensation expense relating to option grants to employees under our stock-based compensation plans using the intrinsic value method. Under this method, we record no compensation expense when we grant stock options to employees if the exercise price for a fixed stock option award granted to an employee is equal to the fair value of the underlying common stock at the date we grant the stock option.

A different method for accounting for employee stock option grants is the fair value method. Under the fair value method, a company is required to determine the fair value of options granted to employees based on an option pricing model which incorporates such factors as the current stock price, exercise price of the options, expected volatility of future movements in the price of the underlying stock, risk-free interest rates, the expected term of the options and any dividends expected to be paid. The fair value determined under this method is then recognized

over the vesting period of the related options.

In addition to option grants, we have granted restricted stock units to certain employees, which were valued at market price at the date of grant. We are recognizing the fair market value of the restricted stock units granted as compensation expense over the vesting period of the units.

In December 2004, FASB issued SFAS 123R. Under SFAS 123R, we will be required to follow a fair value approach using an option-pricing model, such as the Black-Scholes option valuation model, at the grant date of a stock-based award. The compensation calculated under the fair value method will then be recognized over the respective vesting period of the stock-based award. We will adopt the provisions of SFAS 123R during the first quarter of 2006. The adoption of SFAS 123R is expected to have a material impact on our results of operations. Also, SFAS 123R will require us to reflect the tax savings resulting from tax deductions in excess of the expense reflected in our financial statements as a financing cash flow, which may have a material impact on our future reported cash flows from operating activities.

Table of Contents

Results of Operations for the Three Months and Nine Months Ended September 30, 2005 and September 30, 2004

Revenue

Overview

Revenue increased to $34.8 million for the three months ended September 30, 2005 from $29.1 million for the three months ended September 30, 2004. Revenue increased to $102.3 million for the nine months ended September 30, 2005 from $78.7 million for the nine months ended September 30, 2004. The increases in both periods were due to increased sales volumes, both domestically and internationally.

United States

U.S. revenue increased to $20.4 million for the three months ended September 30, 2005 from $16.2 million for the three months ended September 30, 2004. U.S. revenue increased to $53.3 million for the nine months ended September 30, 2005 from $41.9 million for the nine months ended September 30, 2004. The increases in both periods were due to increased direct, U.S. government and distributor sales.

Rest of the world

Revenue from Europe, Africa and the Middle East increased to $7.7 million for the three months ended September 30, 2005, from $7.0 million for the three months ended September 30, 2004 primarily due to an increase in revenue from direct sales in France, an increase in sales to our distributors in Europe and our distributor in India that was partially offset by a decrease in direct sales in Germany. We are taking steps to improve the situation in Germany, including hiring a highly respected and experienced ultrasound executive who we expect will be able to address the issues that have hindered us in Europe's largest market. Revenue increased to $29.0 million for the nine months ended September 30, 2005 from $23.7 million for the nine months ended September 30, 2004. This increase was due primarily due to an increase in sales to our distributors in Italy and India, and an increase in revenue from direct sales in France and Spain that was partially offset by decreases in direct sales in Germany.

Revenue from Canada, South America, Latin America and Asia Pacific (excluding Japan) increased to $3.6 million for the three months ended September 30, 2005 from $2.8 million for the three months ended September 30, 2004 primarily due to an increase in direct sales in Latin America and Australia. Revenue increased to $10.7 million for the nine months ended September 30, 2005 from $6.7 million for the nine months ended September 30, 2004. This increase was primarily due to an increase in sales to our distributors in Latin America and South America, large government sales in South America and an increase in direct sales in Australia and Canada.

Revenue from Japan was $3.1 million for the three months ended September 30, 2005 and September 30, 2004. Revenue from Japan increased to $9.4 million for the nine months ended September 30, 2005 from $6.3 million for the nine months ended September 30, 2004. The increase in the nine-month period was primarily due to sales under our exclusive TITAN distribution arrangement with our distributor, Aloka Co. Ltd., sales under our exclusive iLook system distribution arrangement with our distributor, Nippon Sherwood Medical Industries Ltd., and other direct sales by our Japanese subsidiary.

We anticipate that revenue will increase in 2005 compared to 2004 due to continued expansion of our direct selling efforts in the U.S. and Europe, the expansion of our direct sales operations in Japan, Canada and Australia, the expansion of our sales operations in China, introduction of new products and features, and the overall expansion of market awareness and acceptance of our products. Our subsidiary in Japan has licenses in its name to sell the 180 series, TITAN systems, MicroMaxx systems and iLook systems in Japan. Additionally, the expansion of our sales operations in China may not be as successful as anticipated and we may encounter regulatory and other issues in selling our products there. Our revenue may also be impacted by fluctuations in foreign exchange rates in the countries in which we sell our products in currencies other than the U.S. dollar. Increased competition may also impact the extent of the increase in our anticipated growth in revenue. We currently face competition from larger companies that manufacture cart-based and portable ultrasound systems and have greater financial and other resources. Some of these competitors have introduced hand-carried ultrasound products. We began shipping the MicroMaxx system, which incorporates our third generation ultrasound technology, in mid-June 2005 and it accounted for 33% of total system revenues during the three-month period ended September 30, 2005. Users of cart-based systems may not accept the MicroMaxx system, which could discourage widespread new users and uses for them. Our existing customers may not accept the MicroMaxx system due to pricing and functionality differences. If demand for the MicroMaxx system does not meet our projections, we may experience excess inventory levels and may be unable to generate sufficient revenue to grow our business.

Table of Contents

Gross margin

Gross margin increased to 70% for both the three and nine months ended September 30, 2005 from 67% and 66% for the three and nine months ended September 30, 2004. The increase in gross margin was primarily due to an improved product mix, improved manufacturing efficiencies due to the increased sales volume and the reduction in the royalty owed to ATL, which became effective in September 2004.

We expect our gross margin percentage in 2005 to increase slightly from 2004 due to increased average selling prices, increased manufacturing efficiencies and also due to a reduction in the royalty owed to ATL. Nevertheless, increased competition from existing and new competitors in the portable ultrasound system market could result in lower average realized prices and could lower our gross margin. Our gross margin can be expected to fluctuate in future periods based on the mix of business between direct, government and distributor sales and our product and accessories sales mixes. Changes in our cost of inventory also may impact our gross margin. Adjustments to reduce carrying costs are recorded for obsolete material, earlier generation products and used or refurbished products held either as saleable inventory or as demonstration product. If market conditions change or the introduction of new products by us impacts the market for our previously released products, we may be required to write down the carrying value of our inventory, resulting in a negative impact on gross margins. Additionally, we rely on our sales forecasts by product to determine production volume. To the extent our sales forecasts or product mix estimates are inaccurate, we may produce excess inventory or experience inventory shortages, which may result in an increase in our costs of revenue, a decrease in our gross margin or lost sales. Our gross margin may also be impacted by fluctuations in foreign exchange rates in the countries in which we sell our products in currencies other than the U.S. dollar.

Operating expenses

Research and development expenses were $3.8 million for the three months ended September 30, 2005, compared to $2.9 million for the three months ended September 30, 2004. Research and development expenses were $11.0 million for the nine months ended September 30, 2005, compared to $9.1 million for the nine months ended September 30, 2004. The increases in both periods were primarily due to expenses associated with the development of and enhancements to the MicroMaxx system, which began shipping in mid-June 2005.

We anticipate that research and development expenses will increase in 2005 compared to 2004 due to development related to the MicroMaxx system. However, should our competitors develop products with features that equal or exceed the features that exist in our products, we may incur higher than anticipated research and development costs in order to accelerate existing programs and compete more effectively.

Sales and marketing expenses were $15.5 million for the three months ended September 30, 2005, compared to $12.7 million for the three months ended September 30, 2004. Sales and marketing expenses were $50.3 million for the nine months ended September 30, 2005, compared to $36.4 million for the nine months ended September 30, 2004. The increases in both periods were primarily due to increased compensation for commissions related to the increase in revenue, marketing costs incurred to promote the MicroMaxx system, and expansion of our international operations.

We anticipate that sales and marketing expenses will increase in 2005 compared to 2004 primarily due to marketing expenses associated with the MicroMaxx system, increased compensation for commissions related to the anticipated increase in revenue, expansion of direct sales

operations in Japan, Canada and Australia and continued growth in our European subsidiaries. Additionally, we may incur significant expenses in the expansion of our sales operations in China.

General and administrative expenses were $3.2 million for the three months ended September 30, 2005, compared to $2.7 million for the three months ended September 30, 2004. General and administrative expenses were $9.7 million for the nine months ended September 30, 2005, compared to $7.1 million for the nine months ended September 30, 2004. The increases in general and administrative expenses in the three-month period were related primarily to defending our patent rights in the existing Neutrino patent infringement litigation. The increases in the nine-month period were related primarily to defending our patent rights in the existing Neutrino patent infringement litigation, defending ourselves in a dispute with a former distributor and supporting our business growth.

We anticipate that general and administrative expenses will increase in 2005 compared to 2004 in order to support our increased business activity. Also, we expect to incur substantial additional legal expenses in connection with pending litigation. In addition, we may incur unanticipated legal expenses if we become involved in any new litigation.

Table of Contents

Other income (expense)

For other income and expense, we reported income of $0.5 million for the three months ended September 30, 2005 compared to income of $0.3 for the three months ended September 30, 2004. The increase in 2005 compared to 2004 was primarily due to an increase in interest income, which was caused by an increase in the return on our investments. We reported other income of $0.4 million for the nine months ended September 30, 2005 compared to income of $0.6 million for the nine months ended September 30, 2004. The decrease was primarily due to a $0.7 million increase in net foreign currency losses that were partially offset by an increase in interest income.

Income tax provision

For the three and nine months ended September 30, 2005, we recorded an income tax provision of $1.1 million and $0.8 million, compared to a provision of $0.2 million for the three and nine months ended September 30, 2004. Since the recognition of U.S. deferred tax assets in the fourth quarter of 2004, we record an income tax provision or benefit related to the profitability or loss of our U.S. operations. Our consolidated income tax provision rate during the three and nine months ended September 30, 2005 was 42.7% and 86.9%, which is higher than the expected annual rate of approximately 35% due to the impact of elimination of inter-company profit in consolidation for shipments made to our international subsidiaries, which has the affect of lowering pre-tax income without a corresponding reduction in taxable income. We record a tax provision on U.S. income, but do not record a tax provision or benefit on foreign results because of the 100% valuation allowance on foreign net operating losses. We anticipate that the consolidated tax rate in the fourth quarter will be lower than the consolidated tax rate in the third quarter.

Liquidity and Capital Resources

Our cash and cash equivalents balance was $21.2 million as of September 30, 2005, compared to $17.3 million as of December 31, 2004. Cash and cash equivalents were primarily invested in money market accounts. Our short-term and long-term investment securities totaled $42.8 million as of September 30, 2005, compared to $46.8 million as of December 31, 2004. Investment securities consist of high-grade U.S. government or corporate debt and high-grade asset-backed securities. While our intent is to hold our securities until maturity, we classify all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies.

Operating activities used cash of $5.5 million for the nine months ended September 30, 2005, compared to cash provided of $5.3 million for the nine months ended September 30, 2004. The cash used in 2005 was primarily due to increased inventory in 2005 needed to support higher sales activity, a build-up of MicroMaxx system related inventories related to its introduction and the bulk purchase of certain discontinued integrated circuit chips, which are currently used in our products, an increase in receivables resulting from our increased sales, and a decrease in accounts payable.

We anticipate that cash provided from operations will decrease in 2005 compared to 2004 primarily due to increased inventory in 2005 needed to support higher sales activity, a build-up of MicroMaxx system related inventories related to its introduction and the bulk purchase of certain discontinued integrated circuit chips and an increase in receivables resulting from increased sales.

Investing activities provided cash of $1.0 million for the nine months ended September 30, 2005, compared to cash used of $7.8 million for the nine months ended September 30, 2004. The increase in cash provided in 2005 compared with 2004 was primarily due to $3.5 million of net

sales/maturities of investment securities in 2005 compared to $2.1 million of net purchases of investment securities 2004. Additionally, cash provided by investing activities increased as a result of a reduction in purchases of property and equipment and a reduction in acquisition activities.

We anticipate using cash to invest in high quality investment instruments in 2005, the extent of which will depend on the interest rate environment during the period and the timing of cash flows from our operations during the period.

Financing activities provided cash of $7.5 million for the nine months ended September 30, 2005, compared to $3.6 million for the nine months ended September 30, 2004. The source of cash provided by financing activities in 2005 was the exercise of employee stock options totaling $7.5 million, compared to $3.7 million in 2004.

Table of Contents

We believe that our existing cash and cash generated from operations will be sufficient to fund our operations and planned capital expenditures in 2005. Nevertheless, we may experience an increased need for additional cash due to:

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

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

Our results of operations are subject to significant quarterly variation and periodic fluctuation.

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

- the timing of new product introductions by us or our competitors;
- legal and regulatory costs;
- the timing of orders from major customers and distributors, including bulk orders from governmental entities and demo orders for new distributors;
- seasonal buying patterns of our customers;
- development and promotional expenses relating to new product introductions;
- the revenue mix by product and geography;
- changes in pricing policies by us or our competitors;
- foreign exchange rates;
- fluctuations in our consolidated tax rates;
- our ability to meet demand for our products;
- the market acceptance of our products;
- changes in distribution channels; and
- the ability of our sales force to effectively market and sell our products.

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

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

The market for high-performance, hand-carried ultrasound systems is relatively new. We seek to sell our products to current users of ultrasound, as well as to physicians and other healthcare providers who do not currently use ultrasound. The success of our products depends on their acceptance by the medical community, patients and third-party payers as medically useful, safe and cost-effective.

Table of Contents

In mid-June 2005, we began shipping our newest product, the MicroMaxx system. The MicroMaxx system is based on the third generation of our proprietary ASIC technology.

Competing portable or traditional cart-based ultrasound devices may be more accepted or cost-effective than our products. Physicians and other healthcare providers may adopt our products at a slow rate, if at all. Although customers who are experienced in ultrasound procedures will need little, if any, specialized training to use our products, any new users of ultrasound will require training and education to properly administer ultrasound examinations. If these potential customers are unable or unwilling to be trained due to cost, time constraints, unavailability of courses or other reasons, we could experience limited demand for our products. If the market fails to accept our products, we will be unable to generate sufficient revenue to maintain our business.

If we experience difficulties in manufacturing or selling our new MicroMaxx system, we may fail to meet our 2005 revenue projections or we may incur greater than expected warranty expense.

We began shipping the MicroMaxx system in mid-June 2005 and it accounted for 33% of total system revenue during the three-month period ended September 30, 2005. We will manufacture the MicroMaxx system at our Bothell, Washington facility incorporating components manufactured by various suppliers. If we encounter supplier, regulatory, engineering or technical difficulties in manufacturing the MicroMaxx system, we may incur delays in delivery of these products to customers that could adversely affect our revenues for 2005 and beyond.

Users of cart-based ultrasound systems may not accept the MicroMaxx system, which could discourage widespread new users and uses for them. Our existing customers may not accept the MicroMaxx system due to pricing and functionality differences. If demand for the MicroMaxx system does not meet our projections, we may experience excess inventory levels and may be unable to generate sufficient revenue to grow our business.

Except for certain items that may be shipped with the MicroMaxx system, we include a five-year warranty with the MicroMaxx system. Given the length of the warranty period, the warranty liability for the MicroMaxx system is more difficult to estimate than it has been for our other products that have a one-year warranty. We expect our warranty liability and expense to increase significantly due to the five-year warranty offered with this product. Should actual failure rates and repair or replacement costs differ from estimates, additional warranty expense may be incurred and our results may be materially affected.

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

We currently face competition from companies that manufacture cart-based and portable ultrasound systems. The dominant competitors in this industry are GE Healthcare, a unit of General Electric Company, Siemens AG, and Philips Medical Systems, a unit of Koninklijke Philips Electronics, N.V. These competitors are very large, global organizations and have the following advantages over us:

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

These manufacturers of cart-based and portable ultrasound systems could use their greater resources to increase and withstand competition through various means, including price and payment terms, marketing strategies that bundle the sale of portable systems with other medical products, technological innovation, market penetration, employee compensation, hospital systems integration and complementary services such as warranty protection, maintenance and product training. Existing product supply relationships between these competitors and our potential customers could discourage widespread adoption of our products due to brand loyalty or preferred customer discounts. 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 hand-carried ultrasound markets, we could experience delayed or reduced market acceptance of our products, higher expenses and lower revenue.

Table of Contents

In addition, as the market for high-performance, hand-carried ultrasound 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, Philips Medical Systems, Biosound Esaote, Inc., Medison America Inc., a subsidiary of Medison Company, Ltd., Terason, a division of TeraTech Corporation, and ZONARE Medical Systems, Inc. GE Healthcare has recently introduced the Vivid*i*, a portable cardiac ultrasound system, and previously introduced the LOGIQ Book XP, a general-purpose portable ultrasound system. These competitors may develop highly portable or point-of-care ultrasound systems that offer the same or greater reliability and quality, perform greater or more useful functions or are more cost-effective than our products. Some of these competitors may also be able to use their marketing resources to gain a competitive advantage by more effectively building brand awareness of their products. If we are unable to compete effectively with current or new entrants to the high-performance, hand-carried ultrasound market, we will be unable to generate sufficient revenue to maintain our business.

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, each 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 U.S. and other countries in which we do business are placing increased emphasis on the delivery of more cost-effective medical therapies, which could adversely affect the sale and/or the prices of our products. For example:

- Major third-party payers of hospital and pre-hospital services, including Medicare, Medicaid and private healthcare insurers, have substantially revised their payment methodologies during the last few years which has resulted in stricter standards for reimbursement of hospital and pre-hospital charges for certain medical procedures;
- Numerous legislative proposals have been considered that would result in major reforms in the U.S. healthcare system that could have an adverse effect on our business;
- There has been a consolidation among healthcare facilities and purchasers of medical devices in the U.S. 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.

While we believe that these changes could benefit the sale of lower cost technologies such as ours, these trends could lead to pressure to reduce prices for our products and could cause a decrease in the size of the market or a potential increase in competition that could adversely affect our revenue and profitability, which could have a material adverse effect on our business.

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, we may experience limited market acceptance of our products.

Market acceptance of our products depends in part on the extent to which our customers receive reimbursement for the use of our products from third party payers such as Medicare, Medicaid and private health insurers. Presently, payment policies for physician-performed diagnostic imaging are fairly unrestricted. The continuing efforts of governmental authorities, private health insurers and other third party payers to contain or reduce the costs of healthcare through various means could, however, result in more restricted payment policies for diagnostic imaging. Additionally, traditional providers of imaging examinations in the U.S. have a professional and financial interest in retaining their status as the principal providers of imaging services. These providers have attempted, through legislative means, to modify the reimbursement policies covering the provision of imaging services, including ultrasound imaging, so as to prevent potential new users from receiving payment for ultrasound and other imaging services. If any of these various groups' efforts were to lead Congress to place significant restrictions on the provision of imaging services or the requirements necessary to provide such services, market acceptance of our products could be limited.

As an example, in March 2005, an independent federal advisory group, the Medicare Payment Advisory Commission ("MedPAC"), recommended that the U.S. Congress direct the Secretary of Health and Human Services to set standards for providers wishing to receive reimbursement from the Medicare program for diagnostic imaging services. To date the U.S. Congress has not taken such action. However, the possibility that it could do so in the future remains.

Table of Contents

Additionally, commercial insurers have also taken steps to control utilization of imaging services. For example, Highmark Blue Cross Blue Shield, a commercial insurer operating in Pennsylvania, has recently required that providers meet specific requirements in order to be privileged to provide imaging services to its subscribers in 29 counties in the western part of the state. Proliferation of policies similar to these has the potential to limit acceptance of our products in office markets.

Third party payers may also attempt to reduce healthcare costs by making across-the-board reductions in the payment amount for imaging examinations or eliminating payment altogether for particular types of imaging examinations. As an example, a Medicare payment policy covering physician services effective January 2006 will institute a multiple procedure payment reduction for a select number of ultrasound services when performed in a single session. Payment for the technical component of second and subsequent services performed in the same session on contiguous body parts will be cut by 25% in 2006 and 50% in 2007. In this particular case, the list of procedures covered under this new policy is so small that it is likely to have a negligible impact on total payments to the typical SonoSite customer and thus have no negative impact on demand for our products. However, a broadening of this policy to include additional procedures or the adoption of this type of policy by commercial payers could dampen demand for our products where those purchases are discretionary.

Additionally, to the extent that the use of current or future products that SonoSite may develop is not described by existing Current Procedural Terminology codes or is not covered under existing coverage policies, there is a risk that reimbursement for studies performed with such products could not be attained at all or within a reasonable timeframe. For example, carotid intima media thickness measurement, which is a performed by our SonoCalc IMT software, is not a part of any insurance company's standard benefits package.

International markets are also in the process of responding to increases in healthcare spending by adjusting their reimbursement policies. These responses, like those in the U.S., could similarly affect reimbursement for our products and thereby reduce demand for our products. If similar changes in healthcare reimbursement are adopted in other countries, they could affect our ability to successfully market and sell our products.

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

In order to protect or enforce our patent rights, we may initiate patent litigation. In addition, others may initiate patent litigation against us. We may become subject to interference proceedings conducted in patent and trademark offices to determine the priority of inventions. There are numerous issued and pending patents in the 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. In addition, because patent applications can take many years to result in issued patents and are maintained in confidence by the U.S. Patent and Trademark Office while pending, there may be pending applications of which we are unaware, which may later result in issued patents that our products may infringe. There could also be existing patents of which we are not aware that one or more of our products may infringe. Litigation may be necessary to:

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

We may become involved in the defense and prosecution, if necessary, of intellectual property suits, patent interferences, opposition proceedings and other administrative proceedings. For example, on July 24, 2001, Neutrino filed a complaint against us in U.S. District Court, Southern District of Texas, Houston Division, alleging infringement of the '021 patent by SonoSite as a result of our use, sale and manufacture of the SonoSite 180, SonoSite 180PLUS, SonoHeart and SonoHeart Plus devices. Subsequently, the SonoHeart ELITE, iLook, TITAN and MicroMaxx systems were also added to the lawsuit. The complaint asserts claims for preliminary and permanent injunctive relief enjoining all alleged acts of infringement, compensatory and enhanced damages, attorney's fees and costs, and pre- and post-judgment interest. On August 14, 2001, we filed an answer asserting affirmative defenses of non-infringement and patent invalidity, and included a counterclaim seeking a declaratory judgment of non-infringement and invalidity regarding Neutrino's patent. On October 4, 2001, the court denied a request by Neutrino for preliminary injunctive relief to prevent us from manufacturing and selling our products pending the ultimate disposition of the litigation. On February 20, 2002, in what is known as a "Markman" hearing, the parties presented their arguments regarding the proper construction of Neutrino's patent claims.

Table of Contents

On August 20, 2003, the U.S. District Court in the Southern District of Texas issued a decision interpreting certain terms used in the '021 patent. This decision does not discuss whether the patent is valid or whether the patent would apply to any of our products. In the order, the court, in resolving disputed terms in the Markman hearing, adopted our construction of the term "a portable body designed to be hand held", and adopted Neutrino's construction of the terms "the moveably connected transducer mounting assembly" and "ultrasound emitter". The court denied our motion for summary judgment. We subsequently filed a new summary judgment motion using the court's construction of the claim language that the '021 patent is invalid based on prior art. Neutrino filed a summary judgment motion based on its allegations of infringement.

On September 30, 2004, the Texas court issued its rulings on the summary judgment motions. First, the court denied our motion for summary judgment based on invalidity, finding that there are issues of fact in dispute that must be resolved by a jury at trial. Second, the court granted Neutrino's motion for summary judgment of infringement, finding that the SonoSite products infringe the '021 patent as the court has construed the claims in the Markman hearing. As a result, the court ordered us and Neutrino to enter into mediation, which was required to be completed by January 31, 2005. Mediation was unsuccessful and the court set a jury trial date for the fall of 2005. However, as of the date of this filing, no specific trial date has yet been set. The parties have completed the filing of pretrial motions and expert reports, discovery, and depositions. Prior to the start of trial, the court must rule on numerous motions filed by the parties that are pending before it.

Neutrino also filed suit in the Middle District of Florida on August 19, 2003 against a former SonoSite distributor alleging that the sale of our products by such distributor infringes the '021 patent. SonoSite assumed the defense of the distributor in accordance with our contractual obligations under the distribution agreement. In December 2004, Neutrino agreed to dismissal of all claims in this suit in return for SonoSite's consent to Neutrino's filing of a Second Amended Complaint in the Texas proceeding to add the SonoSite TITAN, SonoHeart ELITE and iLook systems to the Texas suit. Neutrino had also previously filed a similar suit in the Middle District of Tennessee against another medical device distributor for selling a SonoSite product. The Tennessee case was dismissed based on a final judgment and permanent injunction filed a month after the case was filed. The Florida action and the Tennessee judgment have no effect on the Texas proceedings.

We believe that we have good and sufficient defenses to the claims of patent infringement asserted against us by Neutrino and we are vigorously defending ourselves in these matters. If we are not successful in our defense of these claims, we could be forced to pay damages related to past product sales, modify or discontinue selling our products or may enter into royalty or licensing agreements for future product sales, which may not be available on terms acceptable to us, if at all, and which could adversely affect our financial condition, results of operations and cash flow. Sales of the allegedly infringing products represented the majority of our revenue for the nine month periods ended September 30, 2005 and 2004.

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

Our involvement in intellectual property claims and litigation could:

- divert existing management, scientific and financial resources;
- subject us to significant liabilities;
- allow our competitors to market competitive products without obtaining a license from us;
- cause product shipment delays and lost sales;
- require us to enter into royalty or licensing agreements, which may not be available on terms acceptable to us, if at all; or
- force us to modify or discontinue selling our products, or to develop new products.

Our success depends on new product development.

Because substantially all of our revenue comes from the sale of hand-carried ultrasound systems and related products, our financial performance will depend upon market acceptance of, and our ability to deliver and support, new products. We have a continuing research and development program designed to develop new products and improve existing products. The life cycles of our products are difficult to estimate and can be significantly affected by technological changes that are difficult to predict. Factors which could cause delays in our product development schedules or even cancellation of our projects to produce and market these products include:

Table of Contents

- research and development delays;
- competitors producing competing products;
- other products using new technologies emerge; or
- industry or regulatory standards exceeding our products' specifications.

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

Our operations are subject to currency fluctuation and other risks associated with doing business outside the United States.

The percentage of our revenue originating outside the U.S. equaled 48% for the nine months ended September 30, 2005 and 47% for the year 2004. Total sales for the nine months ended September 30, 2005 denominated in a currency other than U.S. dollars ("USDs") were approximately $24.5 million, or 24% of total consolidated revenues. Our revenue from international sales may be adversely affected by any of the following risks:

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

As of September 30, 2005, 56% of our outstanding accounts receivable balance was from international customers, of which 47%, or approximately $9.3 million, was denominated in a currency other than USDs. We regularly review our receivable positions in foreign countries for any indication that collection may be at risk.

We have used and may continue to use forward foreign exchange contracts and other instruments to reduce our exposure to exchange rate fluctuations from intercompany balances denominated in foreign currencies, and we may not be able to reduce this exposure successfully. Accordingly, we may experience economic loss and a negative impact on our results of operations and equity as a result of foreign currency exchange rate fluctuations.

Our establishment, maintenance and expansion of direct sales and distribution operations will require a significant investment of our financial and management resources and may fail to generate a substantial increase in sales.

We have eight wholly-owned sales subsidiaries located in United Kingdom, France, Germany, Spain, Japan, Canada, Australia and China. Establishing, maintaining and expanding these operations will require us to:

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

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

Table of Contents

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

Our manufacturing facilities are located in two buildings in Bothell, Washington, in close proximity to each other. Despite precautions taken by us, a natural disaster such as an earthquake or other unanticipated catastrophic events at this location could significantly impair our ability to manufacture our products and operate our business. Our facilities and certain manufacturing equipment would be difficult to replace and could require substantial replacement lead-time. Such catastrophic events may also destroy any inventory of product or components. While we carry insurance for natural disasters and business interruption for our Bothell facilities, the occurrence of such an event could result in losses that exceed the amount of our insurance coverage, which would impair our financial results.

We, or our independent registered public accounting firm, may determine that we have material weaknesses in our internal controls over financial reporting. As a result, current and potential stockholders could lose confidence in our financial reporting, which would harm our business and the trading price of our stock.

Under Section 404 of the Sarbanes-Oxley Act of 2002, we are required to evaluate and determine the effectiveness of our internal controls over financial reporting. We dedicated a significant amount of time and resources to ensure compliance with this legislation for the year ended December 31, 2004 and will continue to do so for future fiscal periods. We may encounter problems or delays in completing the review and evaluation, the implementation of improvements and the receipt of a positive attestation, or any attestation at all, by our independent auditors. Additionally, management's assessment of our internal controls over financial reporting may identify deficiencies that need to be addressed in our internal controls over financial reporting or other matters that may raise concerns for investors.

As a part of the annual audit of our internal controls over financial reporting and our consolidated financial statements for the year ended December 31, 2004, a material weakness was identified regarding the preparation and review of our tax provision. As of December 31, 2004, we did not have the appropriate level of expertise to properly calculate and review our accounting for income taxes. As a result of this deficiency in our internal control over financial reporting, we did not detect errors in the measurement of income tax amounts as of and for the year ended December 31, 2004. Specifically, the deferred state income tax benefit was misstated due to an error in the calculation of the amount of the state tax NOL carryforwards and was subsequently corrected to reflect the proper measurement of income taxes in accordance with U.S. generally accepted accounting principles. The adjustments and material weakness were limited to income tax calculations and did not impact our revenue, cash flow, or pre-tax income. The tax adjustments represented a control deficiency that constituted a material weakness under the rules specified by the Public Companies Accounting Oversight Board Auditing Standard No. 2. Because of this material weakness, our management concluded that, as of December 31, 2004, we did not maintain effective internal control over financial reporting based on those criteria. As a result, KPMG LLP has issued an adverse opinion with respect to our internal controls over financial reporting and their report is included in our 2004 Annual Report on Form 10-K.

Should we, or our independent registered public accounting firm, determine in future fiscal periods that we have additional material weaknesses in our internal controls over financial reporting, our results of operations or financial condition may be materially adversely affected and the price of our common stock may decline.

We have a history of losses and we may incur losses in the future.

We have incurred net losses in each fiscal year since we commenced operations, with the exception of $23.0 million of net income reported during the year ended December 31, 2004. As of September 30, 2005, we had an accumulated deficit of approximately $64.3 million. We may be unable to sustain or increase future profitability on a quarterly or annual basis. Although we expect to achieve profitability in future periods, we may incur losses if we cannot increase or sustain our revenue. We expect that our operating expenses will increase in the foreseeable future as we expand our sales and marketing infrastructure, our administrative support, our product development activities and our product offerings, including new products incorporating our third generation technology. Our expansion efforts, to be successful, may require more funding than we currently anticipate. Accordingly, we will need to generate significant additional revenue in the future before we will be able to sustain or increase profitability. If we cannot generate such revenue, we may not be profitable. If we fail to achieve sustained profitability, the market price for our common stock will likely fall.

Table of Contents

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

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

In March 2003, one of our component suppliers, Philips, informed us that, commencing in September 2003, it would discontinue production of certain integrated circuit chips used in some of our products. In the second quarter of 2003, we entered into a purchase commitment totaling approximately $3.6 million for supplies of these chips from Philips for our anticipated manufacturing needs. In the fourth quarter of 2004, we entered into an additional purchase commitment with Philips totaling approximately $1.9 million for supplies of these same chips. We have fulfilled our total purchase requirements under both commitments. Demand for our products, however, may exceed our forecasts. Conversely, if demand for our products falls short of our forecasts, we may experience excess inventory of these chips. If our actual demand for these chips varies significantly from our forecasted demand, we may experience delays in manufacturing, lost sales, a write-down of inventory or a deterioration in gross margin.

In addition, our circuit boards are produced by one of the world's largest electronic manufacturing services suppliers who produces the boards in their Thailand manufacturing facility. If we experience delays in the receipt or a deterioration in product yields of these components, we may experience delays in manufacturing or an increase in costs resulting in lost sales or a deterioration in gross margin. The recent tsunami affecting some parts of Thailand has not affected our supply of components.

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

We have experienced rapid growth since our inception as a stand-alone company. Our revenue increased from $73.0 million in 2002 to $84.8 million in 2003 and $115.8 million in 2004. We expect continued significant growth as we continue to develop, manufacture, market and sell our products. Our growth could strain our existing management, operational and financial resources. In order to manage our growth effectively, we will need to expand our manufacturing and quality assurance staff, our sales staff and our international support staff. In addition, we will need to improve the productivity and efficiency of our existing operational, financial and management resources and information systems. Any problems in successfully completing this upgrade may impact our operations and perhaps our financial results. We may be unable to hire and retain the personnel necessary to operate and expand our business. We also may be unable to increase the productivity and efficiency of our existing resources. If we fail to timely improve or augment our existing resources in response to our growth, we may be unable to effectively manage our business and achieve our objectives.

Our consolidated effective income tax rate may fluctuate if our U.S. operations continue to generate profits and our international operations continue to generate losses. Additionally, utilization of our deferred tax assets may be limited and is dependent on future taxable income.

In the fourth quarter of 2004, deferred tax assets relating to our U.S. operations were recognized on our balance sheet resulting in a one-time income tax benefit. Prior to this time, we provided a full valuation allowance against our deferred tax assets. The deferred tax assets primarily represent the income tax benefit of U.S. NOL's we have incurred since inception. As required by SFAS 109, we did not recognize any tax assets on our balance sheet until it was "more likely than not" that the tax assets related to our U.S. operations would be realized on future tax returns. Based upon a recent review of historical operating performance and our expectation that we will generate sustainable U.S. profitability for the foreseeable future, we now believe it is more likely than not that the U.S. deferred tax assets will be fully utilized. We have not reduced our valuation allowance against our deferred tax asset resulting from our international operations because they have sustained consistent losses and have not demonstrated sustainable profitability. Until it is more likely than not that the tax assets related to our international operations can be realized on future tax returns, the tax benefit of any future losses generated by our international operations will not be available to offset any income tax expense recorded for our U.S. operations. Therefore, our consolidated effective income tax rate may fluctuate if our U.S. operations continue to generate profits and our international operations continue to generate losses.

Table of Contents

We will reevaluate our ability to utilize our NOL and tax credit carryforwards in future periods and, in compliance with SFAS No. 109, record any resulting adjustments that may be required to deferred income tax expense. The Tax Reform Act of 1986 contains provisions under section 382 of the Internal Revenue Code that limit the federal NOL carryforwards that may be used in any given year in the event of specified

occurrences, including significant ownership changes. If these specified events occur, we may lose some or all of the tax benefits of these carryforwards. In addition, we will reduce the deferred income tax asset for the benefits of NOL and tax credit carryforwards actually used in future quarters. Therefore, if our U.S. operations continue to generate profits, we will record the related income tax expense for financial reporting purposes based on a blended federal and state rate applied to U.S. income. While this tax expense will reduce net income, no cash will be paid for income taxes, other than required alternative minimum tax and state tax payments, until the NOL and tax credits have been fully utilized. If in the future we determine, based on our assessment of both positive and negative evidence and objective and subjective evidence, which takes into consideration our forecasted taxable income, that it is more likely than not that we will not realize all or a portion of the deferred tax assets, we will record a valuation allowance against deferred tax assets which would result in a charge to income tax expense.

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

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 and in certain U.S. markets. Distributors that are in the business of distributing other medical products may not devote the resources and support required to generate awareness of our products and grow or maintain product sales. If these distributors are unwilling or unable to market and sell our products, we could experience delayed or reduced market acceptance and sales of our products. In addition, if our foreign distributors fail to pay us, or fail to pay us in a timely manner, for the products they have purchased, it may be difficult to recover such monies in a foreign court or proceeding, thereby resulting in the write-off of amounts owed to us.

In addition, disagreements with our distributors or nonperformance by distributors 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. For example, in May 2005, we arbitrated a dispute with our former distributor in the veterinary market. The arbitration panel unanimously found in our favor. We recently appointed a new distributor for the U.S. veterinary market, Aloka Co. Ltd.

The loss of key employees could impair our ability to achieve our business objectives.

Our success depends heavily on our ability to retain the services of certain key employees. 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 certain members of senior management and employees in certain countries outside the U.S. The loss of any of our key employees could significantly delay or prevent the achievement of our product development or business objectives.

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

Our products, our manufacturing activities and the manufacturing activities of our third-party medical device manufacturers are subject to extensive regulation by a number of governmental agencies, including the Federal Drug Administration ("FDA") and comparable international agencies. Our third-party manufacturers and we are or will be required to:

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

Table of Contents

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

We are also subject to regulation in each of the foreign countries in which we sell products. Many of the regulations applicable to our products 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.

The processes 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, it could adversely affect our revenues and profitability. 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.

After a device receives 510(k) clearance, any modification that could significantly affect its safety or effectiveness, or that would constitute a major change in its intended use, will require a new 510(k) clearance or could require pre-market approval. The FDA requires each manufacturer to make this determination initially, but the FDA can review any such decision and can disagree with a manufacturer's determination. If the FDA disagrees with a manufacturer's determination, the FDA can require the manufacturer to cease marketing and/or recall the modified device until 510(k) clearance or pre-market approval is obtained. We have modified aspects of some of our devices since receiving regulatory clearance. Some of those modifications we believe are not significant, and therefore, new 510(k) clearances or pre-market approvals are not required. Other modifications we believe are significant and we have obtained new 510(k) clearances from the FDA for these modifications. In the future, we may make additional modifications to our products after they have received FDA clearance or approval, and in appropriate circumstances, determine that new clearance or approval is unnecessary. However, the FDA may disagree with our determination and if the FDA requires us to seek 510(k) clearance or pre-market approval for any modifications to a previously cleared product, we may be required to cease marketing or recall the modified device until we obtain the required clearance or approval. Under these circumstances, we may also be subject to significant regulatory fines or other penalties.

Every U.S. company that manufactures or assembles medical devices is required to register with the FDA and to adhere to certain quality system requirements which regulate the manufacture of medical devices, prescribe record keeping procedures and provide for the routine inspection of facilities for compliance with such regulations. The FDA also has broad regulatory powers in the areas of clinical testing, marketing and advertising of medical devices.

After a medical device is placed on the market, numerous FDA regulatory requirements apply, including, but not limited to, the following:

- Quality System regulation, which requires manufacturers to follow design, testing, control, documentation and other quality assurance procedures during the manufacturing process;
- Establishment Registration, which requires establishments involved in the production and distribution of medical devices intended for commercial distribution in the U.S. to register with the FDA;
- Medical Device Listing, which requires manufacturers to list the devices they have in commercial distribution with the FDA;
- Labeling regulations, which prohibit "misbranded" devices from entering the market, as well as prohibit the promotion of products for unapproved or "off-label" uses and impose other restrictions on labeling; and
- Medical Device Reporting regulations, which require that manufacturers report to the FDA if their device may have caused or contributed to a death or serious injury or malfunctioned in a way that would likely cause or contribute to a death or serious injury if it were to recur.

Table of Contents

In addition, we are subject to regulations in each of the foreign countries in which we sell products. Currently, our products bear a CE Mark, which indicates that our products comply with the requirements of the applicable European Union Medical Device Directive. Medical devices properly bearing the CE marking may be commercially distributed throughout the European Union. We have received certification from the British Standards Institute for conformity with certain quality system standards allowing us to place the CE mark on our product lines. The ISO 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 British Standards Institute performs periodic assessments of our manufacturing processes. Compliance with the regulations of various agencies, including the Environmental Protection Agency and the Occupational Safety and Health Administration, may require us to incur substantial

costs and may delay or prevent the introduction of new or improved products. Although to date these actions by regulatory bodies have not required us to incur substantial costs or delay product shipments, we expect to experience further inspections and incur additional costs as a result of governmental regulation. Failure to comply with applicable regulatory requirements can result in enforcement action, which may include one or more of the following actions:

- Placing the company under observation and re-inspecting the facilities;
- Issuing a warning letter apprising the company of violative conduct;
- Issuing fines, injunctions, and civil penalties;
- Mandating a recall or seizure of our products;
- Detaining or banning our products;
- Enforcing operating restrictions, partial suspension or a total shutdown of production;
- Refusing our request for 510(k) clearance or pre-market approval of new product versions;
- Revoking 510(k) clearance or pre-market approvals previously granted; and
- Assessing civil or criminal penalties against the company, its officers, or its employees.

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.

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

Much of our value arises out of our proprietary technology and intellectual property for the design, manufacture and use of point-of-care ultrasound imaging systems. Our success and ability to compete effectively depend on our ability to protect our proprietary information. We rely on patent, copyright, trade secret and trademark laws to protect our proprietary technology and limit the ability of others to compete with us using the same or similar technology.

We currently hold 35 patents relating to our technology. A number of other patents are pending in the United States and in foreign jurisdictions. Additionally, we have a license from ATL to use certain ATL technology and ATL technological developments in our hand-carried products. This license was exclusive through April 5, 2003, and became nonexclusive after that date. We also enter into confidentiality and invention ownership agreements with our employees, consultants and corporate partners, and generally control access to, and the distribution of, our product designs, documentation and other proprietary information, as well as the designs, documentation and other information that we license from others.

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

Table of Contents

- unauthorized use of our technology by competitors;
- independent development of the same or similar technology by a competitor, coupled with a lack of enforceable patents on our part;
- failure of our pending patent applications to result in issued patents;
- successful interference actions to our patents, successful patent infringement lawsuits or successful oppositions to our patents and patent applications;
- unauthorized disclosure or use of our proprietary information by former employees or affiliates; and
- failure by our commercial partners to comply with their obligations to share technology or use our technology in a limited manner.

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

Our lack of long-term customer purchase commitments and our limited order backlog make it difficult to predict sales and plan manufacturing requirements, which can lead to lower revenue, higher expense and reduced gross margin.

We do not generally have long-term or volume purchase commitments with our customers, who typically order products on a purchase order basis. In limited 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. Varying sales cycles with our customers make it difficult to accurately forecast component and product requirements. These factors expose us to a number of risks:

- If we overestimate our requirements, we may be obligated to purchase more components or third-party products than is required;
- If we underestimate our requirements, our third-party manufacturers and suppliers may have an inadequate product or product component inventory, which could interrupt manufacturing of our products and result in delays in shipments and lower revenue;
- We may also experience shortages of product components from time to time, which also could delay the manufacturing of our products; and
- Over or under production can lead to higher expense, lower than anticipated revenue, and reduced gross margin.

Effective January 1, 2006, we will be required to account for stock-based awards to employees as a compensation expense that will significantly reduce our net income and earnings per share.

We currently account for stock-based awards to employees using the intrinsic value method in accordance with APB 25. The notes to our financial statements, under the heading "Stock-based compensation," reflects the impact during the three and nine months ended September 30, 2005 and 2004 on our net income (loss) and net income (loss) per share had we determined compensation cost for our stock-based compensation consistent with the method prescribed in SFAS 123. Recent accounting pronouncement SFAS 123R will require us to record compensation expense for stock-based awards to employees in our operations beginning in the first quarter of 2006. This pronouncement will require us to expense the portion of outstanding awards for which the requisite service has not been rendered as of January 1, 2006 under our existing plans as well as any awards made under our 2005 equity incentive plan, which was recently approved by our shareholders. In addition, our shareholders recently approved an employee stock purchase plan ("ESPP"). Based upon the structure of the ESPP, we will be required to record compensation expense for financial statement purposes in connection with the rights to purchase our stock to employees under the ESPP as well. The recording of expenses under this pronouncement will significantly reduce our net income and earnings per share. Our cash flow from operations may also be impacted by income tax benefits on stock options, which are required to be classified as cash provided by financing activities once we adopt SFAS 123R.

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

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

Table of Contents

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

Product liability and other claims and product field actions could increase our costs, delay or reduce our sales and damage our reputation, which could significantly impair our financial condition.

Our business exposes us to the risk of product liability, malpractice or warranty claims inherent in the sale and support of medical device products, including those based on claims that the use or failure of one of our products resulted in a misdiagnosis or harm to a patient. Such claims may 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.

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

As part of our business strategy, we may acquire other companies, products or technologies. We may fail in our attempt to successfully integrate into our business the operations, technology, products, customers, suppliers and personnel of any such acquired business or technology. Even if integration is successful, any such acquisition may include costs for:

- integration of operations, including combining teams and processes in various functional areas;
- market acceptance and integration of new technology into our products;
- fees and expenses of professionals involved in completing the integration process; and
- potential existing liabilities of any future acquisition target.

Additionally, our efforts to consummate an acquisition or to successfully integrate any such acquisition could place a significant burden on our management and internal resources and disrupt our business. If we fail in our attempts to integrate any acquired business or technology, or if the costs and burdens of such acquisition or integration outweigh the benefits of such acquisition, our financial resources or financial results could be impaired.

In May 2004, we acquired 100% of the outstanding common shares of SonoMetric. The results of SonoMetric's operations have been included in our consolidated financial statements since that date. We currently sell a stand-alone version of SonoMetric's software, SonoCalc, that measures the intima media thickness, or IMT, of the carotid artery and have incorporated SonoMetric's software into our newest product, the MicroMaxx system. Since the acquisition, revenue from sales of this software has not been significant. At September 30, 2005, we had approximately $2.3 million of goodwill and intangible assets on our balance sheet related to the SonoMetric acquisition. Because of future contingent payments of up to $4.5 million associated with the SonoMetric acquisition, the total amount of these assets may increase significantly. Any impairment of these assets in the future could result in charges to our operating results.

Table of Contents

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

To meet our long-term funding requirements, we may sell securities in the public or private equity markets if and when conditions are favorable, even if we do not have an immediate need for additional capital at that time. Furthermore, we may enter into financing transactions at prices that represent a substantial discount to market price. In addition, we may issue a significant amount of our securities in connection with our purchase of, or strategic investment in, other businesses or assets. Raising funds or paying for acquisitions through the issuance of equity securities will dilute the ownership of our existing shareholders. A negative reaction by investors and securities analysts to any sale or issuance of our equity securities could result in a decline in the trading price of our common stock.

Additionally, in April 2005 our shareholders approved a new employee stock incentive plan totaling 1,300,000 shares and a new ESPP totaling 1,000,000 shares, which will further dilute the ownership of our existing shareholders.

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

As of September 30, 2005, our executive officers, directors and affiliated entities together beneficially owned approximately 5.9% of the outstanding shares of our common stock. Based on currently available information, seven other shareholders owned in the aggregate approximately 43.6% of the outstanding shares of our common stock. Among these shareholders, Kopp Investment Advisors LLC owned approximately 8.6% of the outstanding shares of our common stock and Amaranth Advisors LLC owned approximately 8.6%. As a result, these shareholders or any other concentrated owner may be able to exert significant influence over all matters requiring shareholder approval, including the election of directors, matters relating to the attraction and retention of employees, such as stock option plans, and approval of significant corporate transactions that could include certain matters relating to future financing arrangements and unsolicited tender offers. This concentration of ownership may delay, deter or prevent a third party from acquiring control over us at a premium over the then-current market price of our common stock, which could result in a decline in our stock price.

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

We license certain technology from ATL that is incorporated into our single technology platform, and we use this ATL technology in all of our hand-carried ultrasound imaging systems. Virtually all of our revenue is attributable to products incorporating this ATL technology.

ATL may terminate our license in the event of an uncured material default by us in our obligations under the license agreement. Although many key aspects of our technology platform, including the high level of miniaturization that allows us to manufacture our systems, are independently owned by us under the terms of our spin-off from ATL, the termination or other loss of our license to use ATL technology would significantly impair our ability to manufacture, market and sell our products. If this license is terminated, we may be unable to generate sufficient revenue to maintain our business.

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

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

Table of Contents

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

- change of control provisions in our license agreement with ATL, which require us to pay ATL $75 million if, at any time through April 6, 2006, any single person or entity engaged in the medical diagnostic imaging business, other than through the sale or manufacture of our products, obtains, directly or indirectly, voting control of a majority of our common stock or the power to elect our entire board of directors;
- acceleration provisions in benefit plans and change-in-control agreements with our employees; and
- our shareholder rights plan, which is designed to dilute a hostile acquiror's interest so that the acquisition becomes prohibitively expensive. Under our rights plan, each of our shareholders has one share purchase right for each share of common stock held, with each right having an exercise price approximating our board of directors' estimate of the long-term value of one share of our common stock. The rights are triggered if an acquiror acquires, or successfully makes a tender offer for, 20% or more of our outstanding common stock. In such event, each shareholder other than the acquiror would have the right to purchase, at the exercise price, a number of newly issued shares of our capital stock at a 50% discount. If the acquiror were to acquire 50% or more of our assets or earning power, each shareholder would have the right to purchase, at the exercise price, a number of shares of acquiror's stock at a 50% discount. Our board of directors may redeem the rights at a nominal cost at any time before a person acquires 20% or more of our outstanding common stock, which allows board-approved transactions to proceed. In addition, our board of directors may exchange all or part of the rights (other than rights held by the acquiror) for such number of shares of our common stock equal in value to the exercise price. Such an exchange produces the desired dilution without actually requiring our shareholders to purchase shares.

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. If ATL were to recognize taxable gain from the spin-off, the Internal Revenue Service ("IRS") could impose that liability on any member of the ATL consolidated group as constituted prior to the spin-off, including us. Generally, the IRS may assert that our spin-off from ATL is a taxable transaction until the expiration of the statute of limitations applicable to ATL with respect to the spin-off transaction. The expiration of the statute of limitations with respect to the spin-off transaction depends upon the actions and tax filings of ATL and the special rules applicable to spin-offs in general, which special rules could result in the extension of the general statute of limitations for an indefinite period of time. In the event of a tax liability, ATL has agreed to cover 85% of any such liability, unless the tax is imposed due to our actions solely or by ATL solely, in which case, we have agreed with ATL that the party who is solely at fault shall bear all of the tax liability. We are unaware of any actions that would result in a tax liability to us under the indemnity agreement regarding the spin-off transaction. We are aware that ATL was acquired in a transaction subsequent to the spin-off transaction, which could potentially result in the spin-off being treated as a taxable transaction, but which resulting tax liability in our view would be the sole responsibility of ATL pursuant to our agreement with ATL. ATL may refuse, however, to indemnify us for a tax liability arising out of the spin-off transaction or may argue that it did not cause the tax liability to be imposed. In such event, we may incur a significant expense for all or a portion of the taxes related to the spin-off.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest rate risk

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

As of September 30, 2005, our portfolio consisted of $19.9 million of interest-bearing debt securities with maturities of less than one year and $22.9 million of interest-bearing debt securities with maturities of more than one year. Our intent is to hold these securities until maturity, but we have classified them as available-for-sale in the event of unanticipated cash needs. The interest bearing securities are subject to interest rate risk and will fall in value if market interest rates increase. We believe that the impact on the fair market value of our securities and related earnings for the remainder of 2005 from a hypothetical 10% increase in market interest rates would not have a material impact on the investment portfolio.

Foreign currency risk

Except for sales transacted by our wholly-owned subsidiaries, we transact all our sales in USDs; therefore, the obligations of many of our international customers are in USDs. Our exposure to risk from fluctuations in foreign currencies relates primarily to the strengthening of the USD against the local currency of our international subsidiaries, which may result in foreign exchange losses on transactions with them, and our international customers, which may impact our ability to collect amounts owed by them.

As of September 30, 2005, 56% of our outstanding accounts receivable balance was from international customers, of which 47%, or approximately $9.3 million, was denominated in a currency other than USDs. The British pound, the European Union euro and the Japanese yen represented the majority of financial transactions executed in a currency not denominated in USDs. We regularly review our receivable positions in foreign countries for any indication that collection may be at risk. In addition, we utilize letters of credit where they are warranted in order to mitigate our collection risk.

We periodically enter into foreign currency forward contracts to reduce the impact of adverse fluctuations on earnings associated with foreign currency exchange rate changes. As of September 30, 2005, we had $28.9 million in foreign currency forward contracts. These contracts expire on December 30, 2005 and serve as hedges of a substantial portion of our intercompany balances denominated in a currency other than the USD. These foreign currencies primarily include the British pound, the European Union euro and the Japanese yen. A sensitivity analysis of a change in the fair value of these contracts indicates that if the USD weakened by 10% against the applicable foreign currency, the fair value of these contracts would decrease by approximately $2.9 million. Conversely, if the USD strengthened by 10% against the applicable foreign currency, the fair value of these contracts would increase by approximately $2.9 million. Any gains and losses on the fair value of these contracts would be largely mitigated by offsetting losses and gains on the underlying transactions. These offsetting gains and losses are not reflected in the sensitivity analysis above. The fair value of these contracts as of September 30, 2005 was not material to our results of operations or our financial position.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

The term "disclosure controls and procedures" is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the Exchange Act). These rules refer to the controls and other procedures of a company that are designed to ensure that the information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our Exchange Act reports is accumulated and communicated to management, including our principal executive officer and our chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Our chief executive officer and our chief financial officer have evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2005, and they have concluded that our disclosure controls and procedures were effective to ensure that the information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

Table of Contents

Changes in internal control over financial reporting

We intend to regularly review and evaluate the design and effectiveness of our internal controls over financial reporting on an ongoing basis and to improve these controls and procedures over time and to correct any deficiencies that we may discover in the future. We have made no changes in our internal controls over financial reporting during the quarter ended September 30, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Material weaknesses had been previously identified in our accounting for income taxes. The errors that were made in the initial income tax provision calculation were limited to a few specific areas and we have since been more diligent in our review of those areas. Additionally, we have hired an employee dedicated solely to the area of taxes, who has the background and expertise to strengthen our tax provision preparation process. We also expect to continue to use a third party tax firm to provide tax preparation and provision guidance.

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

On July 24, 2001, Neutrino filed a complaint against us in U.S. District Court, Southern District of Texas, Houston Division, alleging infringement of the '021 patent by SonoSite as a result of our use, sale and manufacture of the SonoSite 180, SonoSite 180PLUS, SonoHeart and SonoHeart Plus devices. Subsequently, the SonoHeart ELITE, iLook, TITAN and MicroMaxx systems were also added to the lawsuit. The complaint asserts claims for preliminary and permanent injunctive relief enjoining all alleged acts of infringement, compensatory and enhanced damages, attorney's fees and costs, and pre- and post-judgment interest. On August 14, 2001, we filed an answer asserting affirmative defenses of non-infringement and patent invalidity, and included a counterclaim seeking a declaratory judgment of non-infringement and invalidity regarding Neutrino's patent. On October 4, 2001, the court denied a request by Neutrino for preliminary injunctive relief to prevent us from manufacturing and selling our products pending the ultimate disposition of the litigation. On February 20, 2002, in what is known as a "Markman" hearing, the parties presented their arguments regarding the proper construction of Neutrino's patent claims.

On August 20, 2003, the U.S. District Court in the Southern District of Texas issued a decision interpreting certain terms used in the '021 patent. This decision does not discuss whether the patent is valid or whether the patent would apply to any of our products. In the order, the court, in resolving disputed terms in the Markman hearing, adopted our construction of the term "a portable body designed to be hand held", and adopted Neutrino's construction of the terms "the moveably connected transducer mounting assembly" and "ultrasound emitter". The court denied our motion for summary judgment. We subsequently filed a new summary judgment motion using the court's construction of the claim language that the '021 patent is invalid based on prior art. Neutrino filed a summary judgment motion based on its allegations of infringement.

On September 30, 2004, the Texas court issued its rulings on the summary judgment motions. First, the court denied our motion for summary judgment based on invalidity, finding that there are issues of fact in dispute that must be resolved by a jury at trial. Second, the court granted Neutrino's motion for summary judgment of infringement, finding that the SonoSite products infringe the '021 patent as the court has construed the claims in the Markman hearing. As a result, the court ordered us and Neutrino to enter into mediation, which was required to be completed by January 31, 2005. Mediation was unsuccessful and the court set a jury trial date for the fall of 2005. However, as of the date of this filing, no specific trial date has yet been set. The parties have completed the filing of pretrial motions and expert reports, discovery, and depositions. Prior to the start of trial, the court must rule on numerous motions filed by the parties that are pending before it.

Neutrino also filed suit in the Middle District of Florida on August 19, 2003 against a former SonoSite distributor alleging that the sale of our products by such distributor infringes the '021 patent. SonoSite assumed the defense of the distributor in accordance with our contractual obligations under the distribution agreement. In December 2004, Neutrino agreed to dismissal of all claims in this suit in return for SonoSite's consent to Neutrino's filing of a Second Amended Complaint in the Texas proceeding to add the SonoSite TITAN, SonoHeart ELITE and iLook systems to the Texas suit. Neutrino had also previously filed a similar suit in the Middle District of Tennessee against another medical device distributor for selling a SonoSite product. The Tennessee case was dismissed based on a final judgment and permanent injunction filed a month after the case was filed. The Florida action and the Tennessee judgment have no effect on the Texas proceedings.

Table of Contents

We believe that we have good and sufficient defenses to the claims of patent infringement asserted against us by Neutrino and we are vigorously defending ourselves in these matters. If we are not successful in our defense of these claims, we could be forced to pay damages related to past product sales, modify or discontinue selling our products or may enter into royalty or licensing agreements for future product sales, which may not be available on terms acceptable to us, if at all, and which could adversely affect our financial condition, results of operations and cash flow. Sales of the allegedly infringing products represented the majority of our revenue for the nine month periods ended September 30, 2005 and 2004.

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

Item 5. Other Information

As previously reported by SonoSite on a Form 8-K filed on August 1, 2005, on July 26, 2005, the Board of Directors of SonoSite approved, effective immediately, a new cash compensation package for the Company's non-employee members of the Board. That filing contained one inadvertent error in the compensation table in which the former compensation and current compensation amounts for the Board Member "Per Meeting Fee (in person)" were transposed. The corrected table, which replaces the prior table in its entirety, is as follows:

Role	Compensation Element	Former Compensation	Current Compensation
Board Member	Annual Retainer	$20,000	$20,000
	Per Meeting Fee (in person)	$1,000 per meeting series	$1,000 per day
	Per Meeting Fee (by phone)	$0	$500 per day
Lead Independent/Chair	Additional Annual Retainer	$20,000	$20,000
Committee Chairman	Annual Retainer		
	Audit	$0	$10,000
	Compensation	$0	$6,000
	Corporate Governance	$0	$2,000
	Executive	$0	$2,000
Committee Member	Annual Retainer		
	Audit	$0	$5,000
	Compensation	$0	$3,000
	Corporate Governance	$0	$1,000
	Executive	$0	$1,000
	Per Meeting Fee		
	Audit	$0	$0
	Compensation	$0	$0
	Corporate Governance	$0	$0
	Executive	$500	$0

The Company pays meeting fees monthly for any meetings held each month, as well as the annual retainers in 12 monthly installments. Equity compensation remains unchanged. As before, directors who are employed by the Company will receive no additional compensation for their services rendered as directors of the Company.

Table of Contents

Item 6. Exhibits

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

Table of Contents

SIGNATURE

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

SONOSITE, INC.

(Registrant)

Dated: November 9, 2005

By: /s/ MICHAEL J. SCHUH

Michael J. Schuh
Vice President-Finance, Chief Financial Officer
and Treasurer
(Authorized Officer and Principal Financial Officer)

Table of Contents

INDEX TO EXHIBITS

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