SONOSITE INC
Form 10-K
March 26, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

FORM 10-K

x Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2009

OR

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

Commission file no. 0-23791

SONOSITE, INC.

(Exact name of registrant as specified in its charter)

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

21919 30th Drive S.E.

Bothell, WA 98021-3904

(425) 951-1200

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

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

None

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

Common stock, $0.01 par value

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

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

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

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

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

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

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

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

The aggregate market value of the voting stock held by nonaffiliates of the registrant, based on the closing sale price of the registrant s Common Stock on June 30, 2009 as reported on the Nasdaq National Market, was $346,077,799.

As of February 19, 2010, there were 17,465,254 shares of the registrant s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

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

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SONOSITE, INC.

ANNUAL REPORT ON FORM 10-K

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Trademarks

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

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PART I

Our disclosure and analysis in this report and in our 2009 Annual Report to shareholders, of which this report is a part, contain forward-looking statements. Forward-looking statements provide our current expectations or forecasts of future events. Forward-looking statements in this report include, without limitation:

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

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

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

ITEM 1. BUSINESS

Overview

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

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

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

We design our products for applications where ultrasound has not typically been used such as emergency medicine, surgery, critical care, internal medicine, musculoskeletal, and vascular access procedures as well as for imaging in traditional applications, such as radiology, cardiology, vascular medicine and obstetrics and gynecology (OB/Gyn). In addition, the U.S. military has successfully deployed our systems in traditional hospital settings, field hospitals and forward surgical teams in war zones and areas of conflict. We began shipping our first products in September 1999 and today have an installed base of approximately 54,000 systems worldwide.

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

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

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

Medical Ultrasound Imaging

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

Standard ultrasound imaging produces a two-dimensional image, known as grayscale or 2D imaging, which physicians use to diagnose, stage and monitor disease states and conditions. Color Doppler technology expands

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standard ultrasound imaging by generating a colorized image showing the presence and direction of blood flow. Through the use of software algorithms in the ultrasound system, clinicians can provide a quantitative assessment of anatomical structures and physiological functions such as blood flow velocity and cardiac ejection fraction.

ICG Technology

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

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

Our Markets

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

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

Our Strategy

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

Continue to lead the HCU market by building upon and expanding product and technology leadership. We believe our products represent the most advanced and innovative technology available in HCU systems. We are committed to continuing to expand this technological advantage by further enhancing our existing products and creating new ones. As of December 31, 2009, we employed approximately 120 people in research and development. Since our inception in 1998, we have introduced four generations of our hand-carried technology, which have improved performance and expanded clinical capabilities of our systems. The NanoMaxx, based on our fourth generation ASIC

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technology platform, incorporates proprietary technology, advanced imaging technologies, including ColorHD to deliver exceptional image quality in a lightweight, rugged form factor. M-Turbo system and S Series ultrasound tools, also based on our fourth generation technology, provide scalable technology platforms that will enable us to deliver products to specific clinical applications that vary by size, cost and performance.

Maximize the productivity of our direct sales force. As of December 31, 2009, we employed over 175 direct sales representatives in the U.S., Australia, Canada, France, Germany, India, Italy, Japan, Spain and the United Kingdom. To further enhance the productivity of our direct sales force, we will continue to:

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

Acquisition of complimentary companies, products or technology and expansion of our strategic alliances. We believe that other markets offer opportunity for growth, but will require acquisition of or investment in companies, products, or technology or enhancements to our sales distribution channels. We intend to enter into new relationships to develop markets within ultrasound or with ultrasound-dependent technologies. We believe that acquisitions, investments, and strategic alliances can accelerate market penetration to customers not currently served by our direct sales force.

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

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

We believe that the performance, mobility, durability and cost effectiveness of our products are resulting in the creation of new clinical markets for us. We believe that new markets will continue to offer us significant potential for additional growth. Recovery in the U.S. hospital market will also allow our continued domestic expansion.

Our Products

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

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

The following is a summary of our product platforms:

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

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

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

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

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

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

We also offer accessories and clinical education programs including:

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

Specialized training and education. We develop education programs independently and in partnership with numerous medical societies and other recognized experts in ultrasound education to provide courses for our customers through the SonoSite Institute for Training and Education. We have pioneered a unique online education site, which has been developed for the benefit of existing customers in the traditional and emerging markets that are new to the routine use of ultrasound. Additionally, with the introduction of the M-Turbo and S Series we developed the Education Key

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program a USB thumb drive that contains a combination of system operation video tutorials, application-specific video refresher programs that provide peer-to-peer instruction on how to perform specific exams and procedures and an image reference library of application specific sonographic anatomy for comparison purposes. As we develop new and emerging markets, we plan to continue to support the development of accredited and market-specific training materials, and expand the use of workshops in conjunction with recognized leaders in ultrasound.

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

Sales and Marketing

We currently sell our products through sales channels comprised of a direct sales force, independent third-party distributors, and strategic alliances. As of December 31, 2009, we employed over 175 direct sales representatives in the U.S. and in our wholly-owned subsidiaries located in Australia, Canada, France, Germany, India, Italy, Japan, Spain, and the United Kingdom. In addition to our direct sales, we sell products in over 100 countries through a network of independent third-party distributors. In addition, we employ regional sales managers responsible for Africa, Asia, China, Europe, Middle East, and Latin America.

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

We derived 46% of our revenue from domestic sales in 2009 compared to 49% in 2008 and 51% in 2007. We attribute revenue to a foreign country based on the location to which we ship our products. Products sold to the U.S. government but deployed in a foreign country are attributed to domestic revenue. Our quarterly revenue is affected by seasonality from year to year with the fourth quarter having the highest revenue, and first quarter being typically the lowest. Quarterly revenue patterns may be affected somewhat by large government orders or shipment of new product inventory to distributors. We currently have one reporting segment. For information regarding revenues and long-lived assets by geography, refer to Note 16 of our consolidated financial statements.

Patents and Intellectual Property Rights

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

We are committed to developing and protecting our intellectual property and, where appropriate, filing patent applications to protect our technology. We hold 36 U.S. patents relating to various aspects of our products, including digital beamformers, beamforming capabilities, digital conversion circuitry, transceiver circuitry, designs and circuit integration. We hold 40 foreign patents relating to our products, and we currently have 49 patent applications pending in the U.S. and 39 pending registrations abroad.

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

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

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

Competition

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

In October 2009, we granted a non-exclusive worldwide license right to our patent for ultrasound systems weighing less than ten pounds (U.S. Patent No. 5,722,412 or the 412 patent) to GE Healthcare as part of a patent litigation settlement. This is the first such non-exclusive worldwide license right sold. We may encounter increased competition as a result of this license agreement.

Research and Development and Technology

We currently employ approximately 120 people in research and development. In 2009, 2008 and 2007, expenses attributable to research and development for our business totaled $29.0 million, $28.7 million and $25.9 million. We believe our products represent the most advanced and innovative technology in high-performance, HCU systems. We believe our technology gives us a competitive advantage, and we are committed to maintaining this advantage by continuing to enhance our existing products and develop new ones.

Manufacturing

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

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Governmental Regulation

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

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

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

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

Reimbursement

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

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Service and Warranty

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

	Beginning of year	Charged to cost of revenue	Applied to liability	Liability Acquired	End of year
Year ended December 31, 2009	$ 7,094	$ 3,720	$ (2,683)	$ 301	$ 8,432
Year ended December 31, 2008	$ 4,045	$ 4,773	$ (1,724)	$	$ 7,094
Year ended December 31, 2007	$ 2,318	$ 3,160	$ (1,433)	$	$ 4,045

Employees

As of December 31, 2009, we had approximately 730 employees, of which approximately 16% were engaged in product research and development, 21% in manufacturing, 49% in sales and marketing activities and the remaining 14% in administrative capacities, including executive, finance, legal, human resources, regulatory and information services and technology. Of these, approximately 470 are U.S. employees. There has never been a work stoppage and no employees are covered by collective bargaining agreements. We believe our employee relations are good.

Available Information

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

ITEM 1A. RISK FACTORS.

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

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

We seek to sell our products to current users of ultrasound and ICG equipment, physicians, and other healthcare providers who do not currently use ultrasound or ICG equipment. Our market focus, and we believe our greatest growth opportunities, will come from new point-of-care clinical applications and products and new users of ultrasound or ICG technology. Any new users of ultrasound will not only require training and education to properly administer ultrasound examinations but also must develop an appreciation of the treatment value of our products so that our products will become successfully integrated into their day-to-day practices. Although we have spent, and will continue to spend, considerable marketing resources educating potential customers about the value of HCU products in new applications, our efforts may be unsuccessful. If these potential customers are unable or unwilling to be trained due to cost, time constraints, unavailability of courses or other reasons, or if they consider our products nonessential to their medical practices, our ability to expand the market for our products and to increase our revenues could be limited.

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

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

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

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

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

In addition, an acquisition could materially impair our operating results by causing us to incur additional debt or requiring us to incur one-time charges. If we fail in our attempts to integrate any acquired business or technology, or if the business fails to meet our forecasts, our financial resources or financial results could be impaired.

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

Continued demand for our products depends in part on the extent to which our customers continue to receive reimbursement for the use of our products from third-party payers such as Medicare, Medicaid and private health insurers (and equivalent third-party payers in foreign countries). Presently, reimbursement policies for physician-performed diagnostic imaging services are fairly unrestricted in the United States and payment levels are sufficient to enable providers to recoup the costs of purchasing ultrasound systems in a reasonable timeframe. The continuing efforts of governmental authorities, private health insurers and other third-party payers to contain or reduce the costs of healthcare could, however,

result in reduced payment for imaging services or more restrictive payment policies for diagnostic imaging. Some private insurers have implemented imaging privileging programs as a means of controlling utilization of imaging services. Finally, both governmental and private third-party payers are calling for increasing amounts of clinical evidence of beneficial patient outcomes in addition to proof of clinical efficacy as a prerequisite to granting new or continued coverage for technologies and devices.

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

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

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

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

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

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

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

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

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

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

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products or otherwise in operating their businesses, they may become unable to continue to offer the materials we use to manufacture our products, which could result in sales disruption.

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

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

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

- major third-party payers of hospital and non-hospital based healthcare services, including Medicare, Medicaid and private healthcare insurers, could revise their payment methodologies and impose stricter standards for reimbursement of imaging procedures charges and/or a lower or more bundled payment;

- numerous legislative proposals have been considered that would result in major reforms in the U.S. and foreign healthcare systems that could harm our business. For example, the healthcare reform legislation currently under consideration by the U.S. Congress includes an excise tax on medical device manufacturers designed to raise $20 Billion over ten years. If this tax is finalized, beginning in 2013 medical device manufacturers may be required to pay as much as 2.7% of U.S. revenue to meet their obligation.;

- there has been a consolidation among healthcare facilities and purchasers of medical devices in the United States and foreign countries who prefer to limit the number of suppliers from whom they purchase medical products, and these entities may decide to stop purchasing our products or demand discounts on our prices;

- there is economic pressure to contain healthcare costs in worldwide markets; and

- there are proposed and existing laws and regulations in domestic and international markets regulating pricing and profitability of companies in the healthcare industry.

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

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

Because substantially all of our revenue comes from the sales of our existing HCU systems and related products, in order to remain competitive, our future financial success will depend in large part upon our ability to successfully invent, deliver and market new and innovative products and product features. In 2009, 2008 and 2007, we released several new products, including the NanoMaxx ultrasound tool, M-Turbo system and the S Series ultrasound tools, which are customized for different clinical applications. The development of new, technologically advanced products and product features is a complex and uncertain process requiring great innovation and the ability to anticipate technological and market trends and needs. We may be unable to achieve or maintain market acceptance of any new products we develop, and we may be required to expend more costs than anticipated to successfully develop and introduce these products. Without successful product innovation and

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market introduction of new product offerings and feature improvements, our products will become technologically obsolete and we will be unable to compete effectively in the ultrasound market. Additionally, we may be unable to create or introduce new products or features in the CVDM market or any new markets that we may enter. Even with successful innovation and development, we cannot assure you that revenues will continue to remain at or above current levels or that we will continue to be financially profitable.

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

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

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

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

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

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

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

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

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

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

We have eleven wholly owned subsidiaries located in Australia, Canada, China, France, Germany, India, Italy, Japan, Spain, and the United Kingdom. The percentage of our total revenue originating outside the United States equaled 54%, 51% and 49% for the years ended December 31, 2009, 2008 and 2007, respectively. Successful maintenance of these international operations requires us to:

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

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

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

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

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

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

Total sales denominated in a currency other than USD were $84.3 million, or 37% of our total consolidated revenue and total expenses denominated in a currency other than USD were $36.6 million or 25% of our total consolidated operating expenses for the year ended

December 31, 2009. As a result, our results of operations could be adversely affected by certain movements in exchange rates. Although we take steps to hedge a portion of our net foreign currency exposures, there is no assurance that our hedging strategy will be successful or that the hedging markets will have sufficient liquidity or depth for us to implement our strategy in a cost effective manner.

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Additionally, as of December 31, 2009, 67% of our accounts receivable balance was from international customers, of which 58%, or $27.9 million, was denominated in a currency other than USD. Although we regularly review our receivable positions in foreign countries for any indication that collection may be at risk, our revenue from international sales may be adversely affected by longer receivables collection periods and greater difficulty in receivables collection.

If we, or our suppliers, are unable to obtain timely U.S. and foreign governmental regulatory approvals applicable to our products and manufacturing practices, we could experience product introduction delays, production delays, cost increases and lost sales and our future revenues may be adversely affected.

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

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

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

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

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

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

In 2009, our revenue decreased to $227.4 million from $243.5 million in 2008. We intend to continue to grow our business; however, we may be unable to sustain or increase our revenue or profitability on a quarterly or annual basis. We may incur losses if we cannot increase or sustain our revenue. Additionally, operating expenses would increase if we pursue acquisitions of companies or technologies to further our growth.

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

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support staff and our management and information systems. We may be unable to hire and retain the personnel necessary to operate and expand our business. We also may be unable to increase the productivity and efficiency of our existing resources.

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

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

If we overestimate our requirements, we may be obligated to purchase more components or third-party products than we need; and

If we underestimate our requirements or experience shortages of product components from time to time, we could experience an interruption in revenue, because our third-party manufacturers and suppliers may have an inadequate product or product component inventory to satisfy our requirements.

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

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

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

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

In order to protect or enforce our patent rights, we may initiate patent litigation. For example, in 2007, we initiated a lawsuit against Zonare for patent infringement, a case which settled in 2008.

Others may initiate patent litigation against us. For example, in 2007 and again in 2008, GE Healthcare initiated patent litigation against us, alleging that we infringed several of their patents and attempting to invalidate one of our key patents. In 2009, we settled all pending patent litigation worldwide with GE. If we fail to successfully defend claims against us, we may be required to pay monetary damages (including treble damages) and, unless we are able to redesign our products to avoid infringing the asserted patents or to license proprietary rights from them, we may be prevented from continuing to market and sell certain of our products,

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sales of which represent a substantial portion of our total revenue. If this outcome were to occur, we may be unable to redesign our products in a timely and cost effective manner, and licensing proprietary rights may not be possible on commercially reasonable terms, if at all. Even if we are successful in defending these actions and in proving infringement, we will incur substantial costs that could adversely affect our financial condition and the actions will be distracting to management.

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

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

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

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

diversion of management, scientific and financial resources;

exposure to significant adverse judgments and financial liabilities;

substantial litigation costs;

product shipment delays and lost sales;

inability to design around third party patents:

modification of our products; or

discontinuation of product sales.

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

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

We currently hold 76 U.S and foreign patents relating to our technology. A number of other patents are pending in the United States and in foreign jurisdictions. Although we enter into confidentiality agreements with our employees, consultants and strategic partners, and generally control access to and distribution of our proprietary information, the steps we have taken to protect our intellectual property may not prevent misappropriation. In addition, we do not know whether we will be able to defend our proprietary rights since the validity, enforceability and scope of protection of proprietary rights is still evolving.

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

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We may incur greater than expected warranty expense.

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

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

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

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

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

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

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

Our cash and cash equivalents, and investments made up over 50% of our total assets in 2009 and 2008, during which credit and capital markets deteriorated and resulted in impairments on our investment in the Columbia Strategic Cash Portfolio, an investment that was fully liquidated in 2009. Although our holdings are liquid, economic factors could impact the liquidity of our portfolio and result in additional impairments to our investment portfolio, which could negatively affect our financial condition, cash flow and reported earnings.

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

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

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

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

Our spin-off was treated by ATL as a tax-free spin-off under Section 355 of the Internal Revenue Code of 1986, or the Code. If ATL were to recognize a taxable gain from the spin-off, the Internal Revenue Service, or IRS, could impose that liability on any member of the ATL consolidated group as constituted prior to the spin-off, including us. Generally, the IRS may assert that our spin-off from ATL is a taxable transaction until the expiration of the statute of limitations applicable to ATL with respect to the spin-off transaction. The expiration of the statute of limitations with respect to the spin-off transaction depends upon the actions and tax filings of ATL and the special rules applicable to spin-offs in general, which special rules could result in the extension of the general statute of limitations for an indefinite period of time. In the event of a tax liability, ATL has agreed to cover 85% of any such liability, unless the tax is imposed due to our actions solely or by ATL solely, in which case, we have agreed with ATL that the party who is solely at fault shall bear all of the tax liability. We are unaware of any actions that would result in a tax liability to us under the indemnity agreement regarding the spin-off transaction. We are aware that ATL was acquired in a transaction subsequent to the spin-off transaction, which could potentially result in the spin-off being treated as a taxable transaction, but which resulting tax liability in our view would be the sole responsibility of ATL pursuant to our agreement with ATL. ATL may refuse, however, to indemnify us for a tax liability arising out of the spin-off transaction or may argue that it did not cause the tax liability to be imposed. In such event, we may incur a significant expense for all or a portion of the taxes related to the spin-off.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ITEM 1B. UNRESOLVED SEC STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our principal offices are located in Bothell, Washington, where we lease two buildings totaling approximately 125,000 square feet. These facilities include approximately 78,000 square feet of office space and 47,000 square feet of manufacturing and warehouse space. The leases run through 2014. Additionally, we lease smaller office facilities at foreign locations in which we have operations. In 2009, through the acquisition of CDIC we acquired property in Ilmenau, Germany that includes 7,173 square feet of office space.

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ITEM 3. LEGAL PROCEEDINGS

On May 15, 2007, GE Healthcare (GE) filed a lawsuit against us in the federal district court in the Western District of Wisconsin. The lawsuit alleged that certain of our products willfully infringed certain of GE s U.S. patents relating to ultrasound technology. We filed a counterclaim against GE and certain of its affiliates, and filed an answer denying all of GE s claims and alleging that the asserted patents are either invalid, not infringed, or both. In rulings issued on July 24, 2008, the trial judge granted summary judgment motions in our favor on five of the six patents that GE had asserted against us. The court ruled that one of the GE patents is invalid and that our products do not infringe the other four GE patents. The trial judge also granted summary judgment in GE s favor on two of our four asserted patents finding that GE s accused products did not infringe our asserted patents. On July 28, 2008 the parties filed a stipulation for dismissal without prejudice for the remaining claims and counterclaims for the three remaining patents that have yet to be ruled on by summary judgment in this case, thereby negating the need for a trial. On July 31, 2008, the court granted the parties request for dismissal of the remaining claims and counterclaims that had not been ruled on by the judge.

The parties appealed certain of the trial court s summary judgment decisions and other rulings to the Court of Appeals for the Federal Circuit. Oral argument at the Federal Circuit took place in early July 2009.

On May 22, 2008, GE filed a second suit in the same federal court in Wisconsin seeking to invalidate our U.S. patent 5,722,412 (the 412 patent). We counterclaimed that the new ultrasound systems GE proposes to market and sell infringe this patent. The trial was held in early June 2009 and post trial briefing took place during the month of July.

In October 2009, we settled all pending patent litigation worldwide with GE. Under the settlement agreement, both parties agreed to dismiss their claims against each other in all pending litigation. The parties entered into worldwide cross-licenses of the patents in litigation, including a license of the 412 patent by us to GE, and provided each other with mutual releases. In exchange for the 412 license, GE paid an up front fee of $21 million to us and will also make ongoing royalty payments on global sales of hand-carried ultrasound systems produced in the US. We will receive these royalty payments until the 412 patent expires in June 2016. As part of the settlement, we also entered an arrangement with GE to create a foundation to fund research, education and training of best practices for point-of-care ultrasound.

ITEM 4. RESERVED

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PART II

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

Market Information

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

Year	High	Low
2009		
Fourth quarter	$ 29.16	$ 21.89
Third quarter	$ 28.48	$ 18.00
Second quarter	$ 20.80	$ 15.27
First quarter	$ 20.58	$ 15.61
2008		
Fourth quarter	$ 31.29	$ 15.62
Third quarter	$ 38.74	$ 27.17
Second quarter	$ 33.45	$ 27.20
First quarter	$ 39.20	$ 24.57

Dividends

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

Equity Compensation Plan Information

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

Issuer Purchases of Equity Securities

There were no shares repurchased by SonoSite during the fourth quarter of 2009.

Sales of Unregistered Securities

There were no sales of unregistered securities by SonoSite in 2009.

Holders

As of February 19, 2010, there were 2,119 holders of record of our common stock. This figure does not include the number of shareholders whose shares are held of record by a broker or clearing agency, but does include each such brokerage house or clearing agency as a single holder of record.

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Performance Graph

The following performance graph compares the performance of SonoSite s common stock during the five-year period from December 31, 2005 through December 31, 2009 with the performance of the Nasdaq National Market, U.S. Index and the Nasdaq Medical Devices, Instruments and Supplies, Manufacturers Stocks Index. The graph plots the changes in value of an initial $100 investment over the indicated time periods, assuming all dividends are reinvested. Stock prices shown for the common stock are historical and not indicative of future price performances.

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ITEM 6. SELECTED FINANCIAL DATA

The selected financial data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and Notes thereto included elsewhere in this report. Certain amounts reported in comparable prior periods have been adjusted due to the adoption of new accounting guidance related to convertible debt. For additional detail on the adjusted balances, refer to Note 9 in the notes to the consolidated financial statements.

	For the Years Ended December 31,				
	2009	2008 As Adjusted	2007 As Adjusted	2006	2005
		(in thousands, except per share data)			
Statement of Income Data					
Revenue	$ 227,389	$ 243,524	$ 205,068	$ 171,083	$ 147,491
Cost of revenue	69,715	73,715	62,505	49,673	43,652
Gross margin	157,674	169,809	142,563	121,410	103,839
Operating expenses:					
Research and development	29,021	28,698	25,872	20,183	15,195
Sales, general and administrative	115,208	118,679	112,240	97,391	81,752
Total operating expenses	144,229	147,377	138,112	117,574	96,947
Other income:					
Interest income	2,159	9,089	9,662	3,683	1,753
Interest expense	(9,918)	(16,313)	(8,120)		(2)
Other (loss) income	(422)	4,133	1,274	294	(795)
Total other (loss) income	(8,181)	(3,091)	2,816	3,977	956
Income before income taxes	5,264	19,341	7,267	7,813	7,848
Income tax provision	1,981	8,119	2,748	582	2,412
Net income	$ 3,283	$ 11,222	$ 4,519	$ 7,231	$ 5,436
Net income per share:					
Basic	$ 0.19	$ 0.66	$ 0.27	$ 0.44	$ 0.35
Diluted	$ 0.19	$ 0.64	$ 0.26	$ 0.43	$ 0.34
Shares used in computing net income per share:					
Basic	17,239	16,892	16,621	16,274	15,549
Diluted	17,698	17,486	17,168	16,857	16,175

	As of December 31,				
	2009	2008 As Adjusted	2007 As Adjusted	2006	2005
		(in thousands)			
Balance Sheet Data					
Cash and cash equivalents	$ 183,065	$ 209,258	$ 188,701	$ 45,673	$ 26,809
Working capital	343,092	353,479	384,632	147,302	104,999
Total assets	422,974	426,882	456,707	211,894	174,548
Long-term debt, net	92,905	111,336	165,004		

Total shareholders equity	254,430	251,060	229,462	181,031	152,042

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

Overview

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

Our business strategy is to lead in the design, development and commercialization of high performance, innovative ultrasound technology and HCU systems. We intend to sustain long-term growth of our business through technological innovation, broadening of sales distribution channels, entering into and maintaining strategic relationships, expanding into new clinical and geographic markets, and delivering high-quality products to customers. We are focusing on the development of innovative products with the objective of improving patient care and efficiency through ease of use, high performance imaging, and providing quicker results to physicians and clinicians. We also are investing in research and development in existing and new lines of business and other areas that we believe may contribute to our long-term growth. Recognizing that one of our greatest challenges is the current state of the global economy, we are focused on increasing sales force efficiency and effective cost management.

Over the last few years, we have laid a foundation for long-term growth by introducing innovative products, entering into strategic relationships, expanding into new markets, and providing high quality products with an industry-leading 5-year warranty. In fiscal year 2010, we plan to continue to build on this foundation and to execute well in key areas, including continuing to innovate using existing and new technologies, to build and maintain key relationships in the sales distribution channels, to improve sales force productivity, to deliver high quality products, and to manage expenses.

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

Key opportunities include the following:

Product Innovation Our products provide exceptional reliability, image quality, and ease of use in a lightweight design that can be either hand-carried, used on a stand or mounted on a wall or ceiling. We are committed to continuing to develop our next generation of products and expanding our existing product base by using new and existing technologies. In fiscal year 2009, we introduced the NanoMaxx, which is based on our fourth generation product platform, and we acquired the BioZ product line from CDIC. Fiscal year 2010 will continue to see the release of new and innovative products.

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

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

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Results of Operations

The unfavorable global economic environment adversely affected our business in fiscal year 2009, as hospitals cut back or delayed capital spending. Our financial performance during 2009 reflected a decrease in revenue, operating income, and cash flow. But because of our strong and growing product pipeline, we believe that we are well-positioned to manage the continuing uncertainties surrounding the economy. As the global economy recovers and as we enhance our product offerings and strategic alliances, we believe opportunities to increase revenue will grow.

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

	Year Ended December 31,					
	2009		2008 As Adjusted		2007 As Adjusted	
Revenue	$ 227,389	100.0%	$ 243,524	100.0%	$ 205,068	100.0%
Cost of revenue	69,715	30.7	73,715	30.3	62,505	30.5
Gross margin	157,674	69.3	169,809	69.7	142,563	69.5
Operating expenses:						
Research and development	29,021	12.8	28,698	11.8	25,872	12.6
Selling, general and administrative	115,208	50.7	118,679	48.7	112,240	54.7
Total operating expenses	144,229	63.4	147,377	60.5	138,112	67.3
Operating income	13,445	5.9	22,432	9.2	4,451	2.2
Other (loss) income	(8,181)	(3.6)	(3,091)	(1.3)	2,816	1.4
Income before income taxes	5,264	2.3	19,341	7.9	7,267	3.6
Income tax provision	1,981	0.9	8,119	3.3	2,748	1.3
Net income	$ 3,283	1.4%	$ 11,222	4.6%	$ 4,519	2.3%

Revenue

Overall revenue decreased in 2009 compared to 2008 due primarily to a slowdown in hospital capital spending, offset by revenue of $7.1 million from CDIC. The increase in 2008 compared to 2007 was attributable to the higher mix of M-Turbo systems, which has a higher average selling price than the MicroMaxx system, and S Series ultrasound tools; expansion of our international sales channels; and improved U.S. sales productivity. Changes in exchange rates had a 2% unfavorable impact on revenue in 2009 and had a 1% positive impact on revenue in 2008. Revenue by geographic location is as follows:

	Year ended December 31,			Percentage Change	
	2009	2008	2007	2009 Versus 2008	2008 Versus 2007
United States	$ 104,257	$ 118,378	$ 104,147	(12)%	14%
Europe, Africa, and the Middle East	60,382	67,578	57,131	(11)%	18%
Latin America and Canada	20,849	23,667	17,141	(12)%	38%
Asia Pacific	41,901	33,901	26,649	24%	27%
Total revenue	$ 227,389	$ 243,524	$ 205,068	(7)%	19%

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United States

U.S. revenue decreased in 2009 compared to 2008 due primarily to decreased sales in both hospitals and office channels, partially offset by revenue of $6.2 million from CDIC and $0.7 million of patent royalty revenue. The increase in 2008 compared to 2007 was attributable to increased sales of new products and increased sales productivity.

International

Revenue from Europe, Africa and the Middle East decreased in 2009 compared to 2008 primarily due to an unfavorable exchange rate impact of 6% and a decreased sales in Europe resulting from a slowdown in European hospital capital spending, partially offset by revenue of $0.9 million from CDIC. The increase in 2008 compared to 2007 was primarily due to new products and expansion of our sales channel, partially offset by an unfavorable exchange impact of 0.5%.

Revenue from Latin America and Canada decreased in 2009 compared to 2008 due to decreased sales in Latin America and an unfavorable exchange rate of 2%, partially offset by increased sales in Canada. The increase in 2008 compared to 2007 was due to increased sales in Latin America attributable to expansion of the sales channel, partially offset by an unfavorable exchange impact of 1%.

Revenue from Asia Pacific increased in 2009 compared to 2008 primarily due to expansion of our sales channel, increased sales of our higher-end products as well as a favorable exchange rate impact of 2%. The increase in 2008 compared to 2007 was due to increased sales in Australia attributable to new products and a favorable exchange impact of 7.0%.

Fiscal Year 2010 Outlook

We expect revenue to increase up to 10% in 2010 compared to 2009. We expect to introduce new products and features, to develop the cardiovascular disease market, and to continue international expansion. Our revenue may continue to be negatively impacted by economic factors. The expansion of our four vertical markets including hospital, primary care, muscular skeletal, and field medicine, may not be as successful as anticipated and we may encounter regulatory and other issues in selling our products. Introduction of new products may not be as successful as anticipated. Our revenue may also be impacted by fluctuations in foreign exchange rates in the countries in which we sell our products. Increased competition may also impact our anticipated revenue growth. We currently face competition from larger companies that manufacture cart-based and portable ultrasound systems and have greater financial and other resources.

Gross margin

	Years ended December 31,			Percentage of Revenue		
	2009	2008	2007	2009	2008	2007
Gross Margin	$ 157,674	$ 169,809	$ 142,563	69.3%	69.7%	69.5%

Gross margin remained consistent in 2009 compared to 2008 primarily as a result of an improved product mix and maintaining our pricing discipline in a difficult economy, which was offset by an unfavorable exchange impact.

Gross margin remained consistent in 2008 compared to 2007 primarily as a result of the increase in warranty expense, resulting from a shift to products with five year warranties from products with one year warranties, which was offset by the reduction in royalties to ATL, which had expired in September 2007, reduction of material costs, and, favorable impact of foreign exchange rates.

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Fiscal Year 2010 Outlook

We expect gross margins in 2010 to be level with 2009. Increased competition from existing and new competitors as well as pricing pressure due to economic conditions could result in lower average realized prices which could lower our gross margin. Our gross margin can be expected to fluctuate in future periods based on the mix of business between direct, government and distributor sales; mix of U.S. and international sales; and our product and accessories sales mixes. 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. Our cost to provide warranty services may increase if we experience an increase in failure rates or replacement costs differ from our estimates. If market conditions change or the introduction of new products by us impacts the market for our previously released products, we may be required to further write down the carrying value of our inventory, resulting in a negative impact on gross margins. We rely on our sales forecasts by product to determine production volume. To the extent our sales forecasts or product mix estimates are inaccurate, we may produce excess inventory or experience inventory shortages, which may result in an increase in our cost of revenue, a decrease in our gross margin or lost sales. Our gross margin may also be impacted by fluctuations in foreign exchange rates.

Operating expenses

	Years ended December 31,			Percentage of Revenue		
	2009	2008	2007	2009	2008	2007
Research and development	$ 29,021	$ 28,698	$ 25,872	12.8%	11.8%	12.6%
Sales, general, and administrative	$ 115,208	$ 118,679	$ 112,240	50.7%	48.7%	54.7%

Research and development expenses remained flat over 2009 compared to 2008, as we maintained our investment in future technologies despite a challenging economy. The increase in 2008 compared to 2007 was due to development of future new products and features, and further development related to the M-Turbo system and S Series ultrasound tools.

Sales, general and administrative expenses decreased in 2009 compared to 2008 resulting primarily from decreases in legal expenses, stock based compensation and sales compensation expense, offset by CDIC expenses of $7.0 million, integration costs of $4.3 million, and acquisition costs net of bargain purchase gain of $0.4 million. The increase in 2008 compared to 2007 was attributable to increased headcount to support business growth, increased incentive compensation related to improved financial performance, increased stock-based compensation, increased legal costs related to our patent litigation, and increased severance and acquisition costs.

Fiscal Year 2010 Outlook

We anticipate that operating expenses will be up slightly in 2010 compared to 2009.

Other (loss) income, net

	Years ended December 31,			Percentage of Revenue		
	2009	2008	2007	2009	2008	2007
Other (loss) income	$ (8,181)	$ (3,091)	$ 2,816	(3.6)%	(1.3)%	1.4%

Total other loss increased in 2009 compared to 2008 due to lower gains recognized on the repurchase of our debt and a reduction in interest income, resulting from lower interest rates, offset by lower interest expense on our debt due to less outstanding debt. In 2008, we recorded a loss compared to other income in 2007 primarily due to a decrease in interest income, resulting from lower interest rates; higher interest expense, resulting from the first full year of outstanding convertible debt; and foreign currency losses, partially offset by the gain recognized on the partial repurchase of our convertible senior notes during the fourth quarter.

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Fiscal Year 2010 Outlook

We anticipate that other loss will increase in 2010 due to lower interest income as a result of cash used in stock repurchases, slightly offset by less interest expense as a result of less outstanding debt.

Income tax expense

	Years ended December 31,			Effective Tax Rate		
	2009	2008	2007	2009	2008	2007
Income tax provision	$ 1,981	$ 8,119	$ 2,748	37.6%	42.0%	37.8%

The income tax expense is based on a blended federal and state rate applied to U.S. income and the applicable foreign rates applied to foreign income. The decrease in our consolidated effective tax rate in 2009, as compared to 2008, results from a reduced federal statutory rate and an increase for research and experimentation credits, offset by increases in non-deductible expenses and establishing a valuation allowance on our capital loss carryforwards. The increase in our consolidated effective tax rate in 2008, as compared to 2007, results primarily from non-deductible expense associated with a contingent liability incurred as part of the LumenVu acquisition, a tax assessment resulting from an income tax audit in a non-U.S. jurisdiction, an increase in executive compensation subject to Internal Revenue Code Section 162(m) limitations and the impact of reaching the maximum federal marginal tax rate.

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

Fiscal Year 2010 Outlook

We anticipate that our effective tax rate in 2010 will be comparable to fiscal year 2009.

Liquidity and Capital Resources

Our cash and cash equivalents balance was $183.1 million as of December 31, 2009, compared to $209.3 million as of December 31, 2008. Cash and cash equivalents are primarily invested in money market accounts. Our short-term investment securities totaled $74.7 million as of December 31, 2009, compared to short-term and long-term investment securities $70.5 million as of December 31, 2008. Investment securities generally consist of high-grade corporate debt. We have the ability to hold our securities until maturity, however, we classify all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies.

Cash Flows

	Years Ended December 31,		
	2009	2008	2007
Net cash provided by operating activities	$ 21,048	$ 29,171	$ 16,226
Net cash (used in) provided by investing activities	(14,982)	46,628	(86,104)
Net cash (used in) provided by financing activities	(29,789)	(56,347)	214,634
Effect of exchange rate changes on cash and cash equivalents	(2,470)	1,105	(1,728)
Net change in cash and cash equivalents	$ (26,193)	$ 20,557	$ 143,028

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Operating activities provided cash of $21.0 million in 2009, compared to cash provided of $29.2 million in 2008 and $16.2 million in 2007. The decrease in 2009 compared to 2008 was primarily attributable to reduced operational performance, offset by a net decrease in working capital offset by an increase in long-term deferred revenue primarily as a result of a settlement with GE. The increase of cash provided in 2008 compared to 2007 was primarily due to improved operations and reduced spending on inventory and prepaid assets, partially offset by a reduction in payables.

Investing activities used cash of $15.0 million in 2009, compared to $46.6 million provided in 2008 and $86.1 million used in 2007. The increase in cash used in 2009 compared to 2008 was due to the acquisition of CDIC and net purchases of investment securities. The increase in cash provided in 2008 compared to cash used in 2007 was primarily due to an increase in net proceeds from sales and maturities of investment securities of $129.0 million and lower acquisition costs of $3.5 million.

Financing activities used cash of $29.8 million in 2009, used $56.3 million in 2008 and provided $214.6 million in 2007. Less cash was used in financing activities in 2009 compared to 2008 primarily due to less cash used in repurchases of convertible notes, slightly offset by an increase in the repayment of long-term obligations. Cash used in financing activities in 2008 was primarily the result of $68.3 million in repurchases of senior convertible notes and the associated warrant repurchases, partially offset by the sale of call options for $6.4 million and the exercise of stock options and our employee stock purchase plan totaling $4.6 million. This compared to proceeds from the issuance of convertible debt of $217.6 million in 2007, offset by the purchase of the call option intended to partially hedge our convertible note for $28.6 million and issuance of warrants for $19.5 million, and the exercise of stock options and our employee stock purchase plan totaling $5.6 million in 2007.

Fiscal Year 2010 Outlook

We believe that our existing cash and cash generated from operations will be sufficient to fund our operations, capital expenditures, and planned repurchase of up to $150.0 million of our common shares in 2010. Nevertheless, we may experience an increased need for additional cash for potential future acquisitions. Our ability to provide cash from operations will depend on our ability to successfully sell our products, collect our receivables, control our inventories and manage our expenses.

Off-balance sheet arrangements

During the year ended and as of December 31, 2009, we had no off-balance sheet arrangements, other than obligations under our operating leases reflected in the contractual obligations table below. We are not a party to any derivative transactions except for certain foreign exchange rate hedging transactions that we enter into from time to time, discussed more fully under Foreign currency risk in Item 7A below and the call option and warrant instruments indexed to our common stock.

We provide (i) indemnifications of varying scope and size to our customers and distributors against claims of intellectual property infringement made by third parties arising from the use of our products; (ii) indemnifications of varying scope and size to our customers against third party claims arising as a result of defects in our products; (iii) indemnifications of varying scope and size to consultants against third party claims arising from the services they provide to us; and (iv) guarantees to support obligations of some of our subsidiaries such as lease payments. These indemnifications and guarantees require only disclosure. To date, we have not incurred material costs as a result of these obligations and do not expect to incur material costs in the future. Accordingly, we have not accrued any liabilities in our consolidated financial statements related to these indemnifications or guarantees.

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Contractual obligations

We have the following contractual obligations as of December 31, 2009:

	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
			(in thousands)		
Operating lease obligations	$ 12,675	$ 3,754	$ 5,845	$ 2,896	$ 179
Long-term debt obligations (1)	137,269	4,546	9,769	122,723	231
Other long-term obligations (2)	6,344	123	4,394	1,827	
Total Contractual Obligations	$ 156,287	$ 8,423	$ 20,008	$ 127,446	$ 410

(1) Includes interest of 3.75% on convertible senior notes and interest of 5.9% and 5.3% on bank loans assumed in the acquisition of CDIC
(2) Contingent purchase consideration for the acquisition of LumenVu Inc. The consideration is contingent upon achieving milestones related to the technology acquired from LumenVu.

In addition to the amounts shown in the table above, we have $5.2 million of unrecognized tax benefits reflected as either liabilities or as a reduction of deferred tax assets, and we are uncertain as to if or when such amounts may be incurred.

Other commitments

In June 2008, we committed to donating 12 of our systems and two probes per system per year over a four-year period to a research university commencing in 2010 for use in clinical research.

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

In certain countries, we have complemented our direct sales efforts by entering into group purchasing agreements with major healthcare GPOs. Typically, a GPO negotiates with medical suppliers, such as us, on behalf of the GPO s member healthcare facilities, providing such members with uniform pricing and terms and conditions. In exchange, the GPO identifies us as a preferred supplier for its members. Member facilities participating in the GPO s purchasing program can consist of hospitals, medical group practices, nursing homes, surgery centers, managed care organizations, long term care facilities, clinics and integrated delivery networks. These agreements require us to pay fees based on the amount of sales generated from these agreements. We recorded fees related to these agreements as sales and marketing expenses in the amounts of $1.9 million in 2009, $2.1 million in 2008 and $1.8 million in 2007.

Critical Accounting Policies and Estimates

Our critical accounting policies are discussed in Note 2: *Summary of Significant Accounting Policies* of the Notes to the Consolidated Financial Statements. Our consolidated financial statements and accompanying notes are prepared in accordance with U.S. generally accepted accounting principles. Preparing financial statements requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenue, and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to product returns, bad debts, inventories, investments, warranty

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obligations, service contracts, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. The results form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Critical accounting policies for us include revenue recognition, business combinations, valuation of investments and inventories, warranty expense, income taxes, stock-based compensation, and convertible debt.

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

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

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

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

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

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

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

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

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

We have accumulated foreign NOL carryforwards and research and experimentation tax credit carryforwards. Additionally, during 2009, with the acquisition of CDIC we acquired U.S. federal and state NOL carryforwards. We assess our ability to utilize these NOL and tax credit carryforwards in future periods and record any resulting adjustments that may be required to deferred income tax expense. In addition, we reduce the deferred income tax asset for the benefits of NOL and tax credit carryforwards utilized currently. The future impact on net income may therefore be positive or negative, depending on the net result of such adjustments and charges.

Based upon a review of historical operating performance, and our expectation that we will generate profits in the U.S. and our international operations in the foreseeable future, we continue to believe it is more likely than not that the U.S. and international deferred tax assets will be fully realized with the exception of $0.3 million related to capital loss carryforwards and $1.2 million related to CDIC state NOL carryforwards.

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

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

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

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

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

Recent Accounting Pronouncements

In October 2009, the FASB issued Accounting Standards Update No. 2009-14, Software (Topic 985): Certain Revenue Arrangements That Include Software Elements (A Consensus of the FASB Emerging Issues Task Force) (ASU 14) which is an amendment to ASC 985. ASU 14 focuses on determining which arrangements are within the scope of the software revenue guidance in ASC Topic 985 (previously included in AICPA Statement of Position no. 97-2, Software Revenue Recognition) and which are not. ASU 14 removes tangible products from the scope of the software revenue guidance if the products contain both software and nonsoftware components that function together to deliver a product s essential functionality and provides guidance on determining whether software deliverables in an arrangement that includes a tangible product are within the scope of the software revenue guidance. ASU 14 becomes effective for revenue arrangements entered into for fiscal years beginning on or after June 15, 2010. Early adoption is permitted, but requires retrospective application from the beginning of the vendor s fiscal year. We will adopt this pronouncement prospectively beginning in 2010 and believe that this will not have a material impact on our current transactions.

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In October 2009, the FASB issued Accounting Standards Update No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (A Consensus of the FASB Emerging Issues Task Force), (ASU 13). ASU 13 provides principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated, and the consideration allocated. It also requires an entity to allocate revenue in an arrangement using estimated selling prices of deliverables if a vendor does not have vendor-specific objective evidence or third-party evidence of selling price. The guidance eliminates the use of the residual method, requires entities to allocate revenue using the relative-selling-price method and significantly expands the disclosure requirements for multiple-deliverable revenue arrangements. ASU 13 becomes effective for revenue arrangements entered into for fiscal years beginning on or after June 15, 2010. Early adoption is permitted, but requires retrospective application from the beginning of the vendor s fiscal year. We will adopt this pronouncement prospectively beginning in 2010 and believe that this will not have a material impact on our current transactions.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate risk

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

As of December 31, 2009, our investments consisted of $74.7 million of interest-bearing debt securities with maturities or expected maturities of less than one year. Generally we have the ability to hold these securities until maturity, however, we have classified them as available-for-sale in the event of unanticipated cash needs. The interest bearing securities are subject to interest rate risk and will fall in value if market interest rates increase. We believe that the impact on the fair market value of our securities and related earnings for 2010 from a hypothetical 10% increase or decrease in market interest rates would not have a material impact on the investment portfolio.

Foreign currency risk

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

As of December 31, 2009, our intercompany balances denominated in a currency other than USD were $37.3 million. We enter into foreign currency forward contracts to reduce the impact of adverse fluctuations on earnings associated with foreign currency exchange rate changes. As of December 31, 2009, we had $38.9 million in notional amount of foreign currency forward contracts that expire on January 31, 2010. They serve as hedges of a substantial portion of our intercompany balances denominated in a currency other than the USD. These foreign currencies include the British pound, the Canadian dollar, the Euro and the Japanese yen. Gains and losses in the fair value of these contracts are intended to offset the losses and gains, resulting from the changes in the underlying intercompany balances. The fair value of these contracts as of December 31, 2009 was not material to our results of operations or our financial position.

The operating results of our international subsidiaries are translated from their local currency into USD. Total sales for the year ended December 31, 2009 denominated in a currency other than USDs were $84.3 million, or 37% of total consolidated revenues. The British pound, the European Union euro and the Japanese yen represented the majority of financial transactions executed in a currency not denominated in USDs. We use foreign currency forward contracts to hedge the impact of currency fluctuations on the translation of the financial statements of our foreign operations. As of December 31, 2009, we had $7.1 million in notional amount of foreign currency forward contracts expiring at various dates through December 31, 2010. The fair value of these contracts as of December 31, 2009 was not material to our results of operations or our financial position.

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Our foreign currency forward contracts are not eligible for hedge accounting treatment and changes in the fair value of these derivatives are recorded in other income on the consolidated statement of income. A sensitivity analysis of a change in the fair value of these contracts, totaling $46.0 million in notional amount, indicates that if the USD weakened by 10% against the applicable foreign currency, the fair value of these contracts would decrease by approximately $4.6 million. Conversely, if the USD strengthened by 10% against the applicable foreign currency, the fair value of these contracts would increase by approximately $4.6 million. The offsetting gains and losses resulting from the changes in the intercompany balances as described above are not reflected in the sensitivity analysis above.

We transact sales with international customers primarily in USD. We are exposed to risk of fluctuations in their local currency, which may impact our ability to collect amounts owed by them. As of December 31, 2009 67% of our outstanding accounts receivable balance was from international customers, of which 39%, or $27.9 million, was denominated in a currency other than USDs. We regularly review our receivable positions in foreign countries for any indication that collection may be at risk. In addition, we utilize letters of credit where they are considered necessary in order to mitigate our collection risk.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

SONOSITE, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

SonoSite, Inc.:

We have audited the accompanying consolidated balance sheets of SonoSite, Inc. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income, cash flows, and shareholders equity and comprehensive income (loss) for each of the years in the three-year period ended December 31, 2009. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule listed in Item 15(a)(2). These consolidated financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of SonoSite, Inc. and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

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

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), SonoSite Inc. s internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 26, 2010 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP

Seattle, Washington

March 26, 2010

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

SonoSite, Inc.:

We have audited SonoSite, Inc. s internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying management s report on internal control over financial reporting (Item 9A(b)). Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

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

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

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

In our opinion, SonoSite, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of SonoSite, Inc. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income, cash flows and shareholders equity and comprehensive income (loss) for each of the years in the three-year period ended December 31, 2009, and our report dated March 26, 2010 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Seattle, Washington

March 26, 2010

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SONOSITE, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	As of December 31,	
	2009	2008 As Adjusted
ASSETS		
Current Assets		
Cash and cash equivalents	$ 183,065	$ 209,258
Short-term investment securities	74,682	69,882
Accounts receivable, less allowances of $1,471 and $2,190	71,347	66,094
Inventories	32,216	29,115
Deferred tax asset, current	7,350	13,372
Prepaid expenses and other current assets	12,034	6,623
Total current assets	380,694	394,344
Property and equipment, net	9,160	8,955
Investment securities		578
Deferred tax asset, net	775	793
Goodwill	3,902	3,767
Identifiable intangible assets, net	24,018	13,062
Other assets	4,425	5,383
Total assets	$ 422,974	$ 426,882
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 6,175	$ 6,189
Accrued expenses	25,923	31,921
Deferred revenue, current portion	5,504	2,755
Total current liabilities	37,602	40,865
Long-term debt, net	92,905	111,336
Deferred tax liability, net	5,083	9,871
Deferred revenue, net	18,081	1,367
Other non-current liabilities	14,873	12,383
Total liabilities	168,544	175,822
Commitments and contingencies		
Shareholders Equity		
Preferred stock, $1.00 par value Authorized shares 6,000,000 Issued and outstanding shares none		
Common stock, $0.01 par value Shares authorized 50,000,000 Issued and outstanding shares:		
As of December 31, 2009 17,354,355		
As of December 31, 2008 17,054,697	174	171
Treasury stock	(133)	(133)
Additional paid-in capital	287,496	285,890
Accumulated deficit	(32,753)	(36,036)
Accumulated other comprehensive (loss) income	(354)	1,168
Total shareholders equity	254,430	251,060

Total liabilities and shareholders equity	$ 422,974	$ 426,882

See accompanying notes to the consolidated financial statements.

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SONOSITE, INC.

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

	For the Years Ended December 31,		
	2009	2008 As Adjusted	2007 As Adjusted
Revenue	$ 227,389	$ 243,524	$ 205,068
Cost of revenue	69,715	73,715	62,505
Gross margin	157,674	169,809	142,563
Operating expenses:			
Research and development	29,021	28,698	25,872
Sales, general and administrative	115,208	118,679	112,240
Total operating expenses	144,229	147,377	138,112
Other income and (expense):			
Interest income	2,159	9,089	9,662
Interest expense	(9,918)	(16,313)	(8,120)
Gain on convertible note repurchase	1,100	8,246	
Other (expense) income	(1,522)	(4,113)	1,274
Total other (loss) income, net	(8,181)	(3,091)	2,816
Income before income taxes	5,264	19,341	7,267
Income tax provision	1,981	8,119	2,748
Net income	$ 3,283	$ 11,222	$ 4,519
Net income per share:			
Basic	$ 0.19	$ 0.66	$ 0.27
Diluted	$ 0.19	$ 0.64	$ 0.26
Weighted average common and potential common shares outstanding:			
Basic	17,239	16,892	16,621
Diluted	17,698	17,486	17,168

See accompanying notes to the consolidated financial statements.

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SONOSITE, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	For the Years Ended December 31,		
	2009	2008 As Adjusted	2007 As Adjusted
Operating activities:			
Net income	$ 3,283	$ 11,222	$ 4,519
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	5,352	4,125	4,290
Stock-based compensation	6,552	8,709	6,809
Deferred income tax provision	427	3,551	549
Amortization of debt discount and debt issuance costs	5,015	8,305	4,269
Excess tax benefit from stock-based compensation	(144)	(1,025)	(630)
Gain on convertible note repurchase	(1,100)	(8,246)	
Gain on bargain purchase of CardioDynamics	(1,099)		
Other	730	855	(543)
Changes in operating assets and liabilities:			
Accounts receivable	(3,013)	(6,273)	(6,994)
Inventories	153	194	(6,210)
Prepaid expenses and other assets	(3,133)	1,391	(2,210)
Accounts payable	(2,329)	(2,624)	3,009
Accrued expenses	(9,613)	10,014	8,939
Deferred revenue	19,463	(1,453)	597
Deferred liabilities	504	426	(168)
Net cash provided by operating activities	21,048	29,171	16,226
Investing activities:			
Purchase of investment securities	(142,147)	(248,124)	(418,417)
Proceeds from sales/maturities of investment securities	138,323	298,514	339,806
Purchase of property and equipment	(2,586)	(2,841)	(3,341)
Purchase of LumenVu, Inc.			