ALASKA AIR GROUP INC
Form 10-Q
August 08, 2008
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# UNITED STATES

## SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, DC 20549**

# FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2008.

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ________ to ________

Commission file number 1-8957

# ALASKA AIR GROUP, INC.

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **91-1292054** |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |

**19300 International Boulevard, Seattle, Washington 98188**

**(Address of principal executive offices)**

**Registrant s telephone number, including area code: (206) 392-5040**

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

Indicate by check mark whether the registrant is 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 **x** Accelerated filer ¨

Non-accelerated filer ¨ Smaller reporting company ¨

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

The registrant has 36,019,026 common shares, par value $1.00, outstanding at July 31, 2008.

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**ALASKA AIR GROUP, INC.**

**Quarterly Report on Form 10-Q for the three months ended June 30, 2008**

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As used in this Form 10-Q, the terms Air Group, our, we and the Company refer to Alaska Air Group, Inc. and its subsidiaries, unless the context indicates otherwise. Alaska Airlines, Inc. and Horizon Air Industries, Inc. are referred to as Alaska and Horizon, respectively, and together as our airlines.

**Cautionary Note Regarding Forward-Looking Statements**

In addition to historical information, this Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. You can generally identify forward-looking statements as statements containing the words believe, expect, will, anticipate, intend, estimate, assume or other similar expressions, although not all forward-looking statements contain these identifying words. Forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from historical experience or the Company s present expectations. Some of the things that could cause our actual results to differ from our expectations are:

- the competitive environment in our industry;
- changes in our operating costs, including fuel, which can be volatile;
- labor disputes and our ability to attract and retain qualified personnel;
- the timing of disposal and amounts of potential lease termination payments with lessors for our remaining MD-80, CRJ-700 and Q200 leased aircraft and related sublease payments from sublessees, if applicable;
- our significant indebtedness;
- compliance with our financial covenants;
- potential downgrades of our credit ratings and the availability of financing;
- our ability to meet our cost reduction goals;
- operational disruptions;
- general economic conditions, as well as economic conditions in the geographic regions we serve;
- the concentration of our revenue from a few key markets;
- actual or threatened terrorist attacks, global instability and potential U.S. military actions or activities;

- insurance costs;
- our inability to achieve or maintain profitability;
- fluctuations in our quarterly results;
- an aircraft accident or incident;
- liability and other claims asserted against us;
- our reliance on automated systems and the risks associated with changes made to those systems;
- our reliance on third-party vendors and partners;
- changes in laws and regulations; and
- increases in government fees and taxes.

You should not place undue reliance on our forward-looking statements because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond our control. Our forward-looking statements are based on the information currently available to us and speak only as of the date on which this report was filed with the SEC. We expressly disclaim any obligation to issue any updates or revisions to our forward-looking statements, even if subsequent events cause our expectations to change regarding the matters discussed in those statements. Over time, our actual results, performance or achievements will likely differ from the anticipated results, performance or achievements that are expressed or implied by our forward-looking statements, and such differences might be significant and materially adverse to our shareholders. For a discussion of these and other risk factors, see Item 1A: Risk Factors of the Company s annual report on Form 10-K for the year ended December 31, 2007. Please consider our forward-looking statements in light of those risks as you read this report.

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**PART I. FINANCIAL INFORMATION**

**Item 1: Condensed Consolidated Financial Statements**
**CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

Alaska Air Group, Inc.

**ASSETS**

| (in millions) | June 30, 2008 | December 31, 2007 |
|---|---|---|
| **Current Assets** | | |
| Cash and cash equivalents | **$ 179.1** | $ 204.3 |
| Marketable securities | **826.9** | 618.5 |
| Total cash and marketable securities | **1,006.0** | 822.8 |
| Securities lending collateral | **111.3** | 111.9 |
| Receivables - net | **165.0** | 138.0 |
| Inventories and supplies - net | **59.7** | 46.6 |
| Deferred income taxes | **63.4** | 84.9 |
| Fuel hedge contracts | **233.3** | 100.7 |
| Prepaid expenses and other current assets | **95.3** | 85.4 |
| **Total Current Assets** | **1,734.0** | 1,390.3 |
| **Property and Equipment** | | |
| Aircraft and other flight equipment | **3,219.2** | 2,981.2 |
| Other property and equipment | **590.9** | 574.5 |
| Deposits for future flight equipment | **438.4** | 430.0 |
| | **4,248.5** | 3,985.7 |
| Less accumulated depreciation and amortization | **1,106.7** | 1,023.4 |
| **Total Property and Equipment - Net** | **3,141.8** | 2,962.3 |
| **Fuel Hedge Contracts** | **71.9** | 11.8 |
| **Other Assets** | **147.8** | 126.5 |
| **Total Assets** | **$ 5,095.5** | $ 4,490.9 |

See accompanying notes to condensed consolidated financial statements.

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**CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

Alaska Air Group, Inc.

**LIABILITIES AND SHAREHOLDERS EQUITY**

| (in millions except share amounts) | June 30, 2008 | December 31, 2007 |
|---|---|---|
| **Current Liabilities** | | |
| Accounts payable | **$ 84.2** | $ 101.5 |
| Accrued aircraft rent | **56.8** | 59.1 |
| Accrued wages, vacation and payroll taxes | **104.7** | 112.3 |
| Other accrued liabilities | **498.4** | 448.5 |
| Air traffic liability | **532.2** | 364.5 |
| Securities lending obligation | **111.3** | 111.9 |
| Current portion of long-term debt | **262.2** | 175.9 |
| **Total Current Liabilities** | **1,649.8** | 1,373.7 |
| **Long-Term Debt, Net of Current Portion** | **1,444.9** | 1,124.6 |
| **Other Liabilities and Credits** | | |
| Deferred income taxes | **128.1** | 132.6 |
| Deferred revenue | **442.5** | 413.6 |
| Other liabilities | **420.0** | 422.4 |
| | **990.6** | 968.6 |
| **Commitments and Contingencies** | | |
| **Shareholders Equity** | | |
| Preferred stock, $1 par value Authorized: 5,000,000 shares, none issued or outstanding | | |
| Common stock, $1 par value Authorized: 100,000,000 shares Issued: 2008 - 42,915,668 shares 2007 - 42,821,986 shares | **42.9** | 42.8 |
| Capital in excess of par value | **902.4** | 895.1 |
| Treasury stock (common), at cost: 2008 - 6,896,506 shares 2007 - 4,771,306 shares | **(161.4)** | (112.5) |
| Accumulated other comprehensive loss | **(132.8)** | (133.3) |
| Retained earnings | **359.1** | 331.9 |
| | **1,010.2** | 1,024.0 |
| **Total Liabilities and Shareholders Equity** | **$ 5,095.5** | $ 4,490.9 |

See accompanying notes to condensed consolidated financial statements.

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**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)**

Alaska Air Group, Inc.

| (in millions except per-share amounts) | Three Months Ended June 30 2008 | Three Months Ended June 30 2007 | Six Months Ended June 30 2008 | Six Months Ended June 30 2007 |
|---|---|---|---|---|
| **Operating Revenues** | | | | |
| Passenger | **$ 863.5** | $ 836.2 | **$ 1,639.2** | $ 1,532.0 |
| Freight and mail | **27.7** | 27.4 | **49.9** | 48.6 |
| Other - net | **39.6** | 40.8 | **81.2** | 83.2 |
| **Total Operating Revenues** | **930.8** | 904.4 | **1,770.3** | 1,663.8 |
| **Operating Expenses** | | | | |
| Wages and benefits | **234.4** | 236.6 | **476.8** | 473.6 |
| Variable incentive pay | **5.1** | 3.8 | **8.7** | 14.3 |
| Aircraft fuel, including hedging gains and losses | **182.0** | 227.8 | **464.0** | 412.7 |
| Aircraft maintenance | **54.2** | 59.0 | **112.2** | 117.5 |
| Aircraft rent | **42.3** | 44.7 | **85.9** | 88.0 |
| Landing fees and other rentals | **56.9** | 56.5 | **112.9** | 111.2 |
| Contracted services | **43.6** | 39.8 | **88.1** | 78.4 |
| Selling expenses | **44.1** | 41.1 | **78.6** | 80.1 |
| Depreciation and amortization | **51.5** | 43.8 | **100.8** | 85.7 |
| Food and beverage service | **13.4** | 12.8 | **25.7** | 24.0 |
| Other | **61.5** | 57.1 | **118.7** | 112.0 |
| Fleet transition costs - MD-80 | **26.0** | | **26.0** | |
| Fleet transition costs - CRJ-700 | **6.1** | | **6.1** | |
| Fleet transition costs - Q200 | **3.2** | 3.7 | **9.0** | 6.7 |
| **Total Operating Expenses** | **824.3** | 826.7 | **1,713.5** | 1,604.2 |
| **Operating Income** | **106.5** | 77.7 | **56.8** | 59.6 |
| **Nonoperating Income (Expense)** | | | | |
| Interest income | **10.5** | 13.8 | **20.8** | 28.2 |
| Interest expense | **(25.0)** | (22.5) | **(48.4)** | (43.5) |
| Interest capitalized | **6.1** | 6.7 | **12.6** | 13.8 |
| Other - net | **0.1** | (0.7) | **0.3** | (0.9) |
| | **(8.3)** | (2.7) | **(14.7)** | (2.4) |
| Income before income tax | **98.2** | 75.0 | **42.1** | 57.2 |
| Income tax expense | **35.1** | 28.9 | **14.9** | 21.4 |
| **Net Income** | **$ 63.1** | $ 46.1 | **$ 27.2** | $ 35.8 |
| **Basic Earnings Per Share:** | **$ 1.75** | $ 1.14 | **$ 0.75** | $ 0.89 |
| **Diluted Earnings Per Share:** | **$ 1.74** | $ 1.13 | **$ 0.74** | $ 0.88 |
| Shares used for computation: | | | | |
| Basic | 1,058 | | | |

| | | |
|---|---|---|
| Net change in cash and cash equivalents | 11,147 | 3,952 |

| | | |
|---|---|---|
| Cash and cash equivalents at beginning of period | 26,809 | 17,272 |
| Cash and cash equivalents at end of period | $ 37,956 | $ 21,224 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for income taxes | $ 102 | $ 276 |

See accompanying notes to condensed consolidated financial statements.

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**SonoSite, Inc.**
**Notes to Condensed Consolidated Financial Statements**
**(unaudited)**

**Interim Financial Information**

***Basis of Presentation***

The information contained herein has been prepared in accordance with instructions for Form 10-Q and Article 10 of Regulation S-X. The information reflects, in the opinion of SonoSite, Inc. management, all adjustments necessary (which are of a normal and recurring nature) for a fair presentation of the results for the interim periods presented. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of expected results for the entire year ending December 31, 2006 or for any other fiscal period. These financial statements do not include all disclosures required by generally accepted accounting principles. For a presentation including all disclosures required by generally accepted accounting principles, these financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2005, included in our Annual Report on Form 10-K.

***Reclassification of prior period balances***

Certain amounts reported in previous periods have been reclassified to conform to current period presentation.

***Inventories***

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

Inventories consisted of the following (in thousands):

| | As of | |
|---|---|---|
| | **September 30, 2006** | **December 31, 2005** |
| Raw material | $ 8,876 | $ 8,856 |
| Work-in-process | 23 | 58 |
| Demonstration inventory | 5,199 | 4,532 |
| Finished goods | 10,663 | 7,289 |
| Total | $ 24,761 | $ 20,735 |

***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 as well as management's judgment. Our typical warranty period is one year except for the MicroMaxx system, which has, with certain exceptions, a five-year warranty period. We have classified amounts as non-current based upon our estimated timing of repair costs. The current portion of our warranty liability, amounting to $602,000 and $209,000 at September 30, 2006 and December 31, 2005, respectively, is classified in accrued expenses in the accompanying condensed consolidated balance sheet. The warranty is included with the original purchase. In addition to our standard warranty, we sell extended warranty and service agreements for coverage beyond the standard warranty period or coverage above what is covered by the standard warranty. Revenue from sales of extended warranty and service agreements are deferred and recognized over the extended period and such deferred amounts are recorded in Deferred Revenue. The warranty liability is summarized as follows (in thousands):

| | Balance at Beginning of Period | Charged to cost of Revenue | Applied to Liability | Balance at end of Period |
|---|---|---|---|---|
| Three months ended September 30, 2006 | $ 1,494 | $ 620 | $ ( 277) | $ 1,837 |
| Three months ended September 30, 2005 | $ 573 | $ 365 | $ ( 141) | $ 797 |
| Nine months ended September 30, 2006 | $ 995 | $ 1,600 | $ ( 758) | $ 1,837 |
| Nine months ended September 30, 2005 | $ 561 | $ 678 | $ ( 442) | $ 797 |



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***Income taxes***

The income tax provision for the three and nine months ended September 30, 2006 was computed in accordance with Accounting Principles Bulletin ("APB") Opinion No. 28, "Interim Financial Reporting," and Financial Accounting Standards Board ("FASB") Interpretation No. 18, "Accounting for Income Taxes in Interim Periods," and was based on projections of total year pre-tax income and the projected total year tax provision computed in accordance with FASB Statement (" SFAS") No. 109, "Accounting for Income Taxes." Deferred income taxes are provided based on the estimated future tax effects of temporary differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards arising since our inception. Deferred tax assets and liabilities are measured using enacted tax rates that are expected to apply to taxable income in the years in which those temporary differences and carryforwards are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is established when necessary to reduce deferred tax assets to the amount, if any, expected to be realized. The decrease in our consolidated effective tax rate for the nine months ended September 30, 2006, as compared to 2005, results from income tax deductions related to employee dispositions of stock purchased through our employee stock purchase plan prior to the minimum holding period required under the Internal Revenue Code and the transitioning of our foreign subsidiaries to profitability.

***Stock-based compensation***

As of September 30, 2006, we had the following stock compensation plans: the 1998 Nonofficer Employee Stock Option Plan ("1998 NOE Plan"), the 1998 Stock Option Plan ("1998 Plan"), the Nonemployee Director Stock Option Plan ("Director Plan"), the Management Incentive Compensation Plan ("MIC Plan"), the Adjustment Plan, the 2005 Stock Incentive Plan ("2005 Plan") and the 2005 Employee Stock Purchase Plan ("2005 ESPP Plan"). Additionally, through 2004, we granted a total of 165,000 options outside of these plans to corporate officers, which are included within the information presented herein and contain similar provisions to our 1998 Plan.

Prior to adoption of FASB Statement No. 123R, "Share-Based Payment" ("SFAS 123R"), we accounted for those plans under the intrinsic value method in accordance with the provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"). Accordingly, compensation cost related to stock option grants to employees had been recognized only to the extent that the fair market value of the stock exceeded the exercise price of the stock option at the date of the grant. We recognized compensation expense for the fair value of restricted stock unit ("RSU") grants ratably over the applicable vesting period. The fair value was based on the market price of our stock on the date of grant. We recorded share-based compensation related to stock options in accordance with the accelerated methodology described in FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans" ("FIN 28").

On January 1, 2006, we adopted the fair value recognition provisions of SFAS 123R using the modified prospective transition method. SFAS 123R focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions and requires entities to recognize compensation expense for awards of equity instruments to employees based on the grant-date fair value of those awards (with limited exceptions). Prior to the adoption of SFAS 123R, we presented all tax benefits resulting from the exercise of stock options as operating cash inflows in our consolidated statement of cash flows, in accordance with the provision of the Emerging Issues Task Force ("EITF") Issue No.00-15, "Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option." SFAS 123R requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow on a prospective basis, and therefore reduces net operating cash flows and increases net financing cash flows. This amount is shown as "Excess tax benefit from exercise of stock options" on our condensed consolidated statement of cash flows. We use a tax law ordering methodology for determining when tax benefits from stock option exercises are realized. Total cash flows remain unchanged from what have been reported under prior accounting rules.

Total stock-based compensation expense recognized in our consolidated statement of operations for the three and nine months ended September 30, 2006 was $2.3 million and $5.7 million before income taxes and consisted of expense related to stock options of $1.1 million and $3.1 million, RSU awards of $1.0 million and $2.1 million and the employee stock purchase plan of $0.2 million and $0.5 million, respectively. The related deferred tax benefit was $0.8 million and $2.1 million for the three and nine months ended September 30, 2006. The amount of stock-based compensation capitalized to inventory was not material as of September 30, 2006.



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The following table illustrates the impact of our adoption of SFAS 123R on selected line items from our consolidated financial statements for the three months and nine months ended September 30, 2006 (in thousands, except per share data):

| | Three Months Ended September 30, 2006 | | Nine Months Ended September 30, 2006 | |
|---|---|---|---|---|
| | As Reported | Under APB 25 | As Reported | Under APB 25 |
| Income before income taxes | $ 534 | $ 1,809 | $ 1,903 | $ 5,513 |
| Net income | $ 475 | $ 1,355 | $ 1,406 | $ 3,881 |
| Net income per share: | | | | |
| Basic | $ 0.03 | $ 0.08 | $ 0.09 | $ 0.24 |
| Diluted | $ 0.03 | $ 0.08 | $ 0.08 | $ 0.23 |
| Cash flows from operating activities | | | $ 8,454 | $ 10,449 |
| Cash flows from financing activities | | | $ 10,890 | $ 8,895 |

The following table illustrates the effect on net income (loss) and net income (loss) per share if we had applied the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation in 2005 (in thousands, except per share data):

| | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|---|---|---|
| Net income, as reported | $ 1,446 | $ 119 |
| Add: Stock-based compensation expense, as reported, net of related tax effects | 76 | 110 |
| Deduct: Stock-based compensation expense determined under fair value method for all awards, net of tax | ( 804) | ( 2,207) |
| Pro forma net income (loss) | $ 718 | $ ( 1,978) |
| Basic net income (loss) per share: | | |
| As reported | $ 0.09 | $ 0.01 |
| Pro forma | $ 0.05 | $ ( 0.13) |

| | | | | |
|---|---|---|---|---|
| Diluted net income (loss) per share: | | | | |
| As reported | $ | 0.09 | $ | 0.01 |
| Pro forma | $ | 0.04 | $ | (0.13) |

Our results for prior years have not been restated.

The fair value for stock awards was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions for the three and nine months ended September 30, 2006 and 2005:

| | Stock Options | | ESPP |
|---|---|---|---|
| *Three Months Ended* | September 30, 2006 | September 30, 2005 (Pro forma) | September 30, 2006 |
| Expected term (in years) | -- | 6.5 | -- |
| Expected stock price volatility | --% | 53% | --% |
| Risk-free interest rate | --% | 4.0% | --% |
| Expected dividend yield | --% | 0.0% | --% |
| Weighted average fair value of options granted | $-- | $ 17.92 | $ -- |

There were no grants of stock options or issuance from the employee stock purchase plan during the three months ended September 30, 2006.



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| | Stock Options | | ESPP |
|---|---|---|---|
| *Nine Months Ended* | September 30, 2006 | September 30, 2005 (Pro forma) | September 30, 2006 |
| Expected term (in years) | 4.6 | 5.4 | 0.5 |
| Expected stock price volatility | 41 % | 54 % | 26 % |
| Risk-free interest rate | 4.6 % | 3.9 % | 5.0 % |
| Expected dividend yield | 0.0 % | 0.0 % | 0.0 % |
| Weighted average fair value of options granted | $ 16.44 | $ 15.59 | $ 8.74 |

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

The assumptions used to calculate the fair value of options granted are evaluated and revised, as necessary, to reflect market conditions and our experience. In conjunction with the adoption of SFAS 123R, we changed our method of attributing the value of stock-based compensation expense from the accelerated multiple-option approach to the straight-line single-option method. Compensation expense for all stock-based awards granted on or prior to December 31, 2005 will continue to be recognized using the accelerated multiple-option approach, while compensation expense for all stock-based awards granted subsequent to December 31, 2005 will be recognized using the straight-line single-option method. Compensation expense is recognized only for those options expected to vest, with forfeitures estimated at the date of grant based on the Company's historical experience and future expectations. Prior to the adoption of SFAS 123R, the effect of forfeitures on the pro forma expense amounts was recognized as the forfeitures occurred.

*Stock compensation plans*

Under the 1998 NOE Plan, 1998 Plan, MIC Plan, 2005 Plan and option grants outside our stock option plans, as of September 30, 2006, 473,000 shares were available for grant under these stock option plans. In most cases, stock options issued prior to October 22, 2002 are exercisable at 25% each year over a four-year vesting period and have a ten-year contractual term from the grant date. In October 2002, our Board of Directors approved a change in the vesting schedule for employee option grants made after October 22, 2002 so that first-time grants issued to new employees vest 25% after one year of employment and then monthly over the next three years, and grants made to employees after their first year of employment vest monthly over four years. Option grants made under the 2005 Plan to employees during the nine months ended September 30, 2006 vest monthly over three years and grants made to directors vest in full one year following their grant date provided the optionee has continued to serve as our director. Additionally, option grants under the 2005 Plan generally have a seven-year contractual term from the date of grant.

Under the Director Plan, 100,000 shares of common stock were authorized for issuance of stock options at prices equal to the fair market value of our common shares at the date of grant. At September 30, 2006, there were no shares available for grant under this Plan. Stock options are exercisable and vest in full one year following their grant date provided the optionee has continued to serve as our director. Each option expires on the earlier of ten years from the grant date or 90 days following the termination of a director's service as our director.

The 2005 ESPP Plan, which qualifies under Section 423 of the Internal Revenue Code, permits substantially all employees to purchase shares of our common stock. Participating employees may purchase common stock through payroll deductions at the end of each participation period at a purchase price equal to 85% of the lower of the fair market value of the common stock at the beginning or the end of the participation period. As of September 30, 2006, 931,000 shares of common stock were available for issuance under the 2005 ESPP Plan. During the nine months ended September 30, 2006, 41,000 shares of common stock were issued under this plan.



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We also have an Adjustment Plan, which includes options granted in connection with the dividend distribution occurring on April 6, 1998. As part of this distribution, existing ATL Ultrasound, Inc. ("ATL") option holders received one of our options for every six ATL options held. There was no change to the intrinsic value of the option grant, ratio of exercise price to market value, vesting provisions or option period as a result of the distribution. As of September 30, 2006, 7,000 shares of common stock were authorized primarily for issuance upon exercise of stock options at prices equal to the fair market value of our common shares at the date of grant.

*Summary of stock option activity*

The following table presents summary stock option activity for the nine months ended September 30, 2006 (shares presented in thousands):

| | Nine Months Ended September 30, 2006 | | | |
|---|---|---|---|---|
| | Shares | Weighted average exercise price | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value (in thousands) |
| Outstanding, beginning of period | 1,830 | $ 18.95 | | |
| Granted | 437 | $ 39.95 | | |
| Exercised | (458) | $ 17.16 | | |
| Forfeited | (103) | $ 29.60 | | |
| Expired | (12) | $ 18.31 | | |
| Outstanding, end of period | 1,694 | $ 24.21 | 5.74 | $ 12,155 |
| Exercisable, end of period | 1,205 | $ 19.75 | 5.32 | $ 11,358 |

The aggregate intrinsic value in the table above is based on our closing stock price of $28.40 as of September 30, 2006, which would have been received by the optionees, excluding applicable income taxes, had all options been exercised on that date. As of September 30, 2006, total unrecognized stock-based compensation expense related to nonvested stock options was $6.3 million, which is expected to be recognized over a weighted average period of approximately 1.9 years. During the three and nine months ended September 30, 2006, the total intrinsic value of stock options exercised was $0.2 million and $10.4 million.

The Company issues new shares of common stock upon exercise of stock options.

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The following is a summary of stock options outstanding as of September 30, 2006 (shares presented in thousands):

| | Options outstanding | | | Options exercisable | |
|---|---|---|---|---|---|
| Range of exercise prices | Number outstanding | Weighted average remaining contractual life | Weighted average exercise price | Number exercisable | Weighted average exercise price |
| $ 6.35 -- $ 15.24 | 337 | 3.58 | $ 11.25 | 326 | $ 11.24 |
| $ 15.47 -- $ 18.51 | 359 | 5.52 | $ 16.65 | 334 | $ 16.70 |
| $ 18.60 -- $ 27.00 | 364 | 7.10 | $ 22.50 | 311 | $ 22.46 |
| $ 28.19 -- $ 38.97 | 338 | 6.05 | $ 32.68 | 184 | $ 30.19 |
| $ 40.58 | 296 | 6.41 | $ 40.58 | 50 | $ 40.58 |
| | 1,694 | 5.74 | $ 24.21 | 1,205 | $ 19.75 |

*Restricted stock units*

We have granted RSU awards to employees under the 1998 Plan and the 2005 Plan. Generally, the vesting period for our RSU awards is three years from the date of grant. As of September 30, 2006, total unrecognized stock-based compensation expense related to nonvested RSU awards was $10.7 million, which is expected to be recognized over a weighted average period of approximately 2.5 years. During the three and nine months ended September 30, 2006, we recorded stock-based compensation expense related to these RSU awards of $1.0 million and $2.1 million, including $0.1 million of cumulative catch up adjustment that reduced the expense for the effect of forfeitures.

The following table presents summary RSU award activity for the nine months ended September 30, 2006 (shares presented in thousands):

| | Nine Months Ended September 30, 2006 | |
|---|---|---|
| | Shares | Weighted average grant date fair value |
| Non-vested, beginning of period | 93 | $ 33.05 |
| Granted | 365 | $ 36.83 |
| Vested | -- | $ -- |
| Forfeited | (35) | $ 37.70 |

| | | |
|---|---|---|
| Non-vested, end of period | 423 | $ 35.93 |

The total fair value of RSU awards vested during the nine months ended September 30, 2006 was zero.

***Net income per share***

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



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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Net income | $ 475 | $ 1,446 | $ 1,406 | $ 119 |
| Weighted average common shares outstanding used in computing basic net income per share | 16,366 | 15,630 | 16,229 | 15,461 |
| Effect of dilutive stock options and restricted stock units | 537 | 655 | 628 | 639 |
| Weighted average common shares outstanding used in computing diluted net income per share | 16,903 | 16,285 | 16,857 | 16,100 |
| Net income per share: | | | | |
| Basic | $ 0.03 | $ 0.09 | $ 0.09 | $ 0.01 |
| Diluted | $ 0.03 | $ 0.09 | $ 0.08 | $ 0.01 |

We exclude equity instruments from the calculation of diluted weighted average shares outstanding if the effect of including such instruments is anti-dilutive to net income per share. Accordingly, certain equity instruments totaling 617,000 and 322,000 shares for the three and nine months ended September 30, 2006 and 10,000 and 148,000 shares for the three and nine months ended September 30, 2005 have been excluded from the calculation of diluted weighted average shares.

***Accumulated other comprehensive income***

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

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |

| | | | | |
|---|---|---|---|---|
| Net income | $ 475 | $ 1,446 | $ 1,406 | $ 119 |
| Other comprehensive income (loss): | | | | |
| Foreign currency translation adjustment | ( 17) | ( 44) | 235 | ( 381) |
| Unrealized holding gains (losses) arising during the period | 208 | ( 92) | 180 | ( 71) |
| Less reclassification adjustment for losses included in net income | 9 | 3 | 6 | 13 |
| Comprehensive income (loss) | $ 675 | $ 1,313 | $ 1,827 | $ ( 320) |





***Indemnification Obligations and Guarantees (excluding product warranty)***

We apply the disclosure provisions of FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45") to our agreements that contain guarantee or indemnification clauses. We provide (i) indemnifications of varying scope and size to our customers and distributors against claims of intellectual property infringement made by third parties arising from the use of our products; (ii) indemnifications of varying scope and size to our customers against third party claims arising as a result of defects in our products; (iii) indemnifications of varying scope and size to consultants against third party claims arising from the services they provide to us; and (iv) guarantees to support obligations of some of our subsidiaries such as lease payments. These indemnifications and guarantees give rise only to the disclosure provisions of FIN 45.

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

***Contingencies***

In March 2006, we prevailed in a patent infringement suit that had been pending against us in federal court in Texas since 2001. Following is a chronology of this lawsuit. On July 24, 2001, Neutrino Development Corporation ("Neutrino") filed a complaint against us in U.S. District Court, Southern District of Texas, Houston Division, alleging infringement of U.S. Patent 6,221,021, or the '021 patent, by SonoSite as a result of our use, sale and manufacture of the SonoSite 180, SonoSite 180PLUS, SonoHeart and SonoHeart Plus devices (the "Original Products"). Subsequently, the SonoHeart ELITE, iLook, TITAN and MicroMaxx systems were also added to the lawsuit (the "New Products"). The complaint asserted claims for preliminary and permanent injunctive relief enjoining all alleged acts of infringement, compensatory and enhanced damages, attorney's fees and costs, and pre- and post-judgment interest.

In October 2001, Neutrino's motion for preliminary injunction was denied. In February 2002, the district court held a Markman hearing to interpret certain claims in the '021 patent and issued its claim construction in August 2003. In September 2004, the district court granted Neutrino's motion for summary judgment of infringement, finding that SonoSite's Original Products infringe the '021 patent as the district court construed the claims in the Markman hearing. Following this decision, the parties prepared for a jury trial on the issues of infringement by SonoSite's New Products and validity of the '021 patent, filing various motions, including motions for summary judgment. On March 21, 2006, the district court granted SonoSite's motion for summary judgment of patent invalidity based on new matter. The district court found that Neutrino improperly amended the '021 patent in violation of the U.S. patent laws to include a description of a component being handheld which was not disclosed in the original patent application. In a final judgment, the district court declared that the claims being asserted against SonoSite in the '021 patent are invalid for new matter, vacated and set aside its September 2004 ruling on infringement, and dismissed Neutrino's claims and causes of action "with prejudice".

The plaintiff has filed a notice of appeal to the U.S. Court of Appeals for the Federal Circuit in Washington, D.C. Both parties have filed their appellate briefs and oral argument will take place on December 5, 2006. We expect that a decision by the appellate court would not issue until mid-to-late 2007. Our motions to declare the case "exceptional," and to recover our attorneys' fees and costs are pending in the district court. We believe that the appellate court will uphold the district court's decision. If we are not successful in the appeal, and the case is reversed and remanded to the district court for a jury trial, and we are not successful in defending these claims in a jury trial, we could be forced to pay damages related to past product sales, modify or discontinue selling our products or may enter into royalty or licensing agreements for future product sales, which may not be available on terms acceptable to us, if at all, and which could adversely affect our financial condition, results of operations and cash flow. Sales of the allegedly infringing products represent the majority of our revenue.

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

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***Segment reporting***

We currently have one reporting segment. We market our products in the United States and internationally through our direct sales force and our indirect distribution channels. Our chief operating decision maker evaluates resource allocation decisions and our performance based upon revenue recorded in geographic regions and does not receive financial information about expense allocation on a disaggregated basis. Geographic regions are determined by the shipping destination. Revenue by geographic location for the three months and nine months ended September 30, 2006 and 2005 are as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| United States | $ 23,406 | $ 20,390 | $ 61,781 | $ 53,282 |
| Europe, Africa and the Middle East | 9,286 | 7,672 | 32,799 | 28,972 |
| Japan | 3,003 | 3,103 | 8,769 | 9,369 |
| Canada, South and Latin America | 2,536 | 1,754 | 8,360 | 7,233 |
| Asia Pacific | 2,115 | 1,890 | 5,021 | 3,433 |
| Total revenue | $ 40,346 | $ 34,809 | $ 116,730 | $ 102,289 |

***Recent accounting pronouncements***

In July 2006, the FASB issued Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 clarifies the recognition threshold and measurement of a tax position taken on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. FIN 48 also requires expanded disclosure with respect to the uncertainty in income taxes. We are currently evaluating the requirements of FIN 48 and the impact this interpretation may have on our consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"), which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 is effective as of the end of our 2006 fiscal year, allowing a one-time transitional cumulative effect adjustment to beginning retained earnings as of January 1, 2006 for errors that were not previously deemed material, but are material under the dual method guidance in SAB 108. We are currently evaluating the impact of adopting SAB 108 on our financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measures" ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value and enhances disclosures about fair value measures required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We are currently reviewing the provisions of SFAS 157 to determine the impact on our consolidated financial statements.

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

This quarterly report on Form 10-Q contains forward-looking statements. Forward-looking statements provide our current expectations or forecasts of future events. Forward-looking statements 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.



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

We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures we make on related subjects in our future quarterly reports on Form 10-Q, current reports on Form 8-K and annual reports on Form 10-K. Also note that we provide a cautionary discussion of risks, uncertainties and possibly inaccurate assumptions relevant to our business in Item 1A. "Risk Factors" sections of our Annual Report on Form 10-K for the year ended December 31, 2005. These are risks that could cause our actual results to differ materially from those anticipated in our forward-looking statements or from our expected or historical results. Other factors besides the risks, uncertainties and possibly inaccurate assumptions described in this report could also affect actual results.

**Overview**

We are the world leader in hand-carried ultrasound ("HCU"). We specialize in the development of HCU systems for use in a variety of medical specialties and a range of clinical settings. Our proprietary technologies have enabled us to design hand-carried ultrasound 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 out of the imaging lab to the point-of-care such as the patient's bedside or the physician's examining table.

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 clinical research that accelerates the adoption of HCU to improve patient outcomes. By providing ultrasound at the primary point-of-care, our systems can eliminate delays associated with the outpatient referral process or moving heavy, cart-based systems across hospital departments to scan patients. This increased accessibility is changing clinical practice, improving patient care and safety and has the potential to reduce healthcare costs through earlier and more rapid diagnosis of diseases and conditions.

We design our products for applications where ultrasound has not typically been used such as emergency medicine, anesthesiology, surgery, critical care, internal medicine 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 both traditional hospital settings, field hospitals and forward surgical teams in Iraq and other areas of conflict. We began shipping our first products in September 1999 and today have an installed based of more than 25,000 systems worldwide.

On April 18, 2005, we introduced our newest product, the SonoSite MicroMaxx (R) system ("MicroMaxx system"). This system is our third generation product and is based on our proprietary Application Specific Integrated Circuit ("ASIC") technology for high-resolution ultrasound imaging and offers image resolution comparable to costly, conventional cart-based ultrasound systems weighing over 200 pounds. Our first shipments of the MicroMaxx system occurred in June 2005. The system addresses both traditional and emerging ultrasound markets and includes a standard five-year warranty on the system and most of the transducers, a first in the ultrasound industry.

Our first generation of products includes the 180 (TM) and iLook (R) series. The SonoSite 180PLUS (TM) system was designed for general ultrasound imaging and the SonoHeart (R) ELITE is specifically configured for cardiovascular applications. The iLook 25 imaging tool is designed to provide visual guidance for physicians and nurses while performing vascular access procedures, and the iLook 15 imaging tool is designed to provide imaging of the chest and abdomen. Our second generation product, the TITAN (R) system, began shipping in June 2003.



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**Critical Accounting Policies and Estimates**

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

As discussed in Item 7, "Management Discussion and Analysis of Financial Condition and Results of Operations" of our annual report on Form 10-K for the year ended December 31, 2005, our critical accounting policies and estimates include accounts receivable, revenue recognition, valuation of inventories, goodwill, intangible assets, warranty expense, income taxes and stock-based compensation. With the adoption of SFAS 123R as of January 1, 2006, we are replacing "Stock-Based Compensation" with the following.

*Stock-Based Compensation*. On January 1, 2006, we adopted FAS 123R, which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including restricted stock units, stock options and employee stock purchases under a stock purchase plan based on estimated fair values. Under FAS 123R, we use the Black-Scholes option pricing model as our method of valuation for stock-based awards. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected stock price volatility over the expected life of the award and actual and projected exercise and forfeiture behaviors. Although the fair value of stock-based awards is determined in accordance with FAS 123R, the Black-Scholes option pricing model requires the input of various subjective assumptions, and other reasonable assumptions could provide differing results.

**Results of Operations**

**Revenue**

Revenue increased to $40.3 million for the three months ended September 30, 2006 from $34.8 million for the three months ended September 30, 2005. Revenue increased to $116.7 million for the nine months ended September 30, 2006 from $102.3 million for the nine months ended September 30, 2005. The increase in 2006 compared to 2005 was due to increased direct sales offset by decreased U.S. enterprise sales and lower sales in some of our international markets. Sales of the MicroMaxx system, which has a higher average selling price than previous systems and began shipping in June 2005, accounted for 53.4% of total system revenues during the three months ended September 30, 2006.

***United States***

U.S. revenue increased to $23.4 million for the three months ended September 30, 2006 from $20.4 million for the three months ended September 30, 2005. U.S. revenue increased to $61.8 million for the nine months ended September 30, 2006 from $53.3 million for the nine months ended September 30, 2005. U.S. revenue was lower than expected due to the integration of our sales channel partner addressing the physician office market and the redeployment of our core direct sales to the hospital point-of-care markets. The increase in the third quarter 2006 compared to 2005 was primarily attributable to increased direct sales. The increase during the nine months of 2006 compared to 2005 was due to increased direct sales offset by a decrease in U.S. government and enterprise sales. Revenues to U.S. government declined in comparison to the prior year due to large project orders included in the first quarter of 2005.

***International***

Revenue from Europe, Africa, India and the Middle East increased to $9.3 million for the three months ended September 30, 2006 from $7.7 million for the three months ended September 30, 2005, primarily due to an increase in revenue from Europe offset by decreases in sales to our distributors in Italy, Middle East and Africa. Revenue from Europe, Africa, India and the Middle East increased to $32.8 million for the nine months ended September 30, 2006 from $29.0 million for the nine months ended September 30, 2005. The increases were primarily due to increased sales in Europe, offset by decreases in Italy. Revenue from Canada, South and Latin America and Asia Pacific (excluding Japan) increased to $4.7 million for the three months ended September 30, 2006 from $3.6 million for the three months ended September 30, 2005. Revenue from Canada, South and Latin America and Asia Pacific (excluding Japan) increased to $13.4 million for the nine months ended September 30, 2006 from $10.7 million for the nine months ended September 30, 2005. The increase during the three and nine months of 2006 compared to 2005 was primarily due to increased sales in Canada, Australia and Latin America.



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Revenue from Japan decreased to $3.0 million for the three months ended September 30, 2006 from $3.1 million for the three months ended September 30, 2005. Revenue from Japan decreased to $8.8 million for the nine months ended September 30, 2006 from $9.4 million for the nine months ended September 30, 2005. The decrease was primarily due to reduced TITAN system sales to a distributor as we introduced the MicroMaxx system into our distribution network. During the second quarter we began distribution to our new partner, Fukuda Denshi, for distribution of certain of our products into office physician markets and hospital point of care markets.

We anticipate that overall revenue will increase in 2006 compared to 2005 due to continued expansion of our direct selling efforts in the U.S., Europe, Canada and Australia, as well as our international distributors in Europe, Middle East, and India, the expansion of our sales operations in China, improvement in the sales operations in Germany, introduction of new product features, and the overall expansion of market awareness and acceptance of our products. In the U.S. we recently launched an alternate sales channel focused on the physician office market. However, the expansion of our sales operations in China, India, Japan and into the U.S. office market may not be as successful as anticipated and may take longer than expected. We may encounter regulatory and other issues in selling our products in these markets. Our revenue may also be impacted by fluctuations in foreign exchange rates in the countries in which we sell our products in currencies other than the USD. Increased competition may also impact the extent of the increase in our anticipated growth in revenue. We currently face competition from larger companies, such as General Electric Healthcare, that manufacture cart-based and portable ultrasound systems and have greater financial and other resources. Some of these competitors have introduced HCU products, including GE Healthcare.

**Gross margin**

Gross margin was 71.0% for the three months ended September 30, 2006 and 70.4% for the three months ended September 30, 2005. Gross margin was 71.3% for the nine months ended September 30, 2006 and 69.9% for the nine months ended September 30, 2005. The gross margin increased over the prior year quarter and prior year-to-date as a result of increased sales of MicroMaxx systems which generate a higher margin than our earlier generation products and manufacturing efficiencies due to higher volume and lower costs for MicroMaxx components.

We expect our gross margin percentage in 2006 to increase slightly from 2005 due to increased average selling prices, which result from changes in product mix, and due to increased manufacturing efficiencies. Nevertheless, increased competition from existing and new competitors in the portable ultrasound system market could result in lower average realized prices and could lower our gross margin. Our gross margin can be expected to fluctuate in future periods based on the mix of business between direct, government and distributor sales and our product and accessories sales mixes. Changes in our cost of inventory also may impact our gross margin. Adjustments to reduce carrying costs are recorded for obsolete material, earlier generation products and used or refurbished products held either as saleable inventory or as demonstration product. If market conditions change or the introduction of new products by us impacts the market for our previously released products, we may be required to write down the carrying value of our inventory, resulting in a negative impact on gross margins. Additionally, we rely on our sales forecasts by product to determine production volume. To the extent our sales forecasts or product mix estimates are inaccurate, we may produce excess inventory or experience inventory shortages, which may result in an increase in our costs of revenue, a decrease in our gross margin or lost sales. Our gross margin may also be impacted by fluctuations in foreign exchange rates in the countries in which we sell our products in currencies other than the USD.

**Operating expenses**

Research and development expenses were $5.4 million for the three months ended September 30, 2006, compared to $3.8 million for the three months ended September 30, 2005. Research and development expenses were $14.1 million for the nine months ended September 30, 2006, compared to $11.0 million for the nine months ended September 30, 2005. The increase was primarily due to increased stock-based compensation expenses recorded following the adoption of SFAS 123R on January 1, 2006 of $0.5 million and $1.3 million for the three and nine months ended September 30, 2006 and increased headcount to support further development of our ASIC technology and the MicroMaxx system.

We anticipate that research and development expenses will increase in 2006 compared to 2005 due to stock-based compensation, development related to our next generation of hand-carried technology and further development related to the MicroMaxx system. Also, we may incur higher than anticipated research and development costs in order to accelerate existing programs.

Sales and marketing expenses were $20.0 million for the three months ended September 30, 2006, compared to $15.5 million for the three months ended September 30, 2005. Sales and marketing expenses were $58.9 million for the nine months ended September 30, 2006, compared to $50.3 million for the nine months ended September 30, 2005. The increase was attributable to increased stock-based compensation of $0.7 million and $2.2 million for the three and nine months ended September 30, 2006, increased emphasis on education, and expansion of our U.S. sales force and international operations offset by the reduction in costs associated with the launch of MicroMaxx in 2005.



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We anticipate that sales and marketing expenses will increase in 2006 compared to 2005 primarily due to stock-based compensation, marketing expenses for education and brand awareness, increased compensation for commissions related to the anticipated increase in revenue, and continued expansion of direct sales operations in Japan, Canada, Australia and in our European subsidiaries. Additionally, we may incur significant expenses in the expansion of our operations in China and India.

General and administrative expenses were $3.9 million for the three months ended September 30, 2006, compared to $3.2 million for the three months ended September 30, 2005. General and administrative expenses were $11.3 million for the nine months ended September 30, 2006, compared to $9.7 million for the nine months ended September 30, 2005. The increase was attributable to increased stock-based compensation of $1.0 million and $2.4 million for the three and nine months ended September 30, 2006 and increased headcount to support business growth, offset by a reduction in legal expenses.

We anticipate that general and administrative expenses, other than stock-based compensation, will not increase in 2006 compared to 2005 due to decreased legal expenses.

**Other income (expense)**

Total other income (expense) was $1.1 million for the three months ended September 30, 2006 compared to $0.5 million for the three months ended September 30, 2005. Total other income (expense) was $2.9 million for the nine months ended September 30, 2006 compared to $0.4 million for the nine months ended September 30, 2005. The increase was due to an increase in interest income, which was caused by higher cash balances and higher average interest rates, and a reduction in the foreign currency transaction loss from 2005.

**Income tax expense**

Income tax expense was $0.1 million for the three months ended September 30, 2006, compared to $1.1 million for the three months ended September 30, 2005. Income tax expense was $0.5 million for the nine months ended September 30, 2006, compared to $0.8 million for the nine months ended September 30, 2005. The decrease in our consolidated effective tax rate for the nine months ended September 30, 2006, as compared to 2005, results from income tax deductions related to employee dispositions of stock purchased through our employee stock purchase plan prior to the minimum holding period required under the Internal Revenue Code and the transitioning of our foreign subsidiaries to profitability. We anticipate that our annual consolidated effective tax rate will be 31%, excluding income tax deductions related to dispositions of stock purchased through the employee stock purchase plan and any impact of a reduction to our valuation allowance for foreign deferred tax assets based on an evaluation of the weight of all positive and negative evidence.

**Liquidity and Capital Resources**

Our cash and cash equivalents balance was $38.0 million as of September 30, 2006, compared to $26.8 million as of December 31, 2005. Cash and cash equivalents were primarily invested in money market accounts. Our short-term and long-term investment securities totaled $48.0

million as of September 30, 2006, compared to $44.0 million as of December 31, 2005. Our short-term investments increased to $40.7 million as of September 30, 2006 from $25.4 million as of December 31, 2005 due to the ability to achieve returns on short-term investments that are comparable with returns on long-term investment and at the same time provide greater investment flexibility. Investment securities consist of high-grade U.S. government or corporate debt and high-grade asset-backed securities. 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.

Operating activities provided cash of $8.5 million for the nine months ended September 30, 2006, compared to cash used of $5.5 million for the nine months ended September 30, 2005. Net income for the nine months ended September 30, 2006 was adjusted by non-cash stock-based compensation expense of $5.7 million, depreciation and amortization of $2.5 million and deferred income taxes of $0.5 million. Changes in operating assets used $2.9 million and changes in operating liabilities provided $3.4 million. Additionally, as of September 30, 2006, inventory had increased by $4.0 million from December 31, 2006 to support higher planned sales levels for the seasonally strong fourth quarter and an increase in demo inventory to support our education initiatives and international expansion. Also, as of September 30, 2006, our days sales outstanding ("DSO") increased by nine days with DSOs for U.S. based receivables decreasing and DSOs for international based receivables increasing due to longer payment cycles of international sales. SFAS 123R requires the non-cash benefits for tax deductions in excess of compensation expense calculated based on the fair value of the award to be reported as a financing cash flow and thus adjusted out of operating cash flows. Accordingly, cash from operating activities for the nine months ended September 30, 2006 was reduced by $2.0 million.

We anticipate that cash provided by operations will increase in 2006 compared to a use of cash in 2005 primarily due to anticipated continued profitable operations. This increase will depend on our ability to successfully sell our products, collect our receivables, control our inventories and manage our expenses. Our cash flow from operations will also be impacted by excess income tax benefits from the exercise of stock options, however, the amounts and timing of option exercising cannot be predicted.





Investing activities used cash of $7.6 million for the nine months ended September 30, 2006, compared to cash provided of $1.0 million for the nine months ended September 30, 2005. The cash used in 2006 was primarily due to net purchases of investment securities of $3.7 million compared to net proceeds of $3.5 million in 2005.

Financing activities provided cash of $10.9 million for the nine months ended September 30, 2006, compared to $7.5 million for the nine months ended September 30, 2005. Cash provided by financing activities was due to proceeds from the exercise of stock options and employee stock purchase plan totaling $8.9 million in 2006 compared to $7.5 million in 2005. Additionally, SFAS 123R requires the non-cash benefits of $2.0 million for tax deductions in excess of recognized compensation expense, calculated based on the fair value of the award, to be reported as a source of cash from financing activities.

We believe that our existing cash and cash generated from operations will be sufficient to fund our operations and planned capital expenditures in 2006. Nevertheless, we may experience an increased need for additional cash due to:

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

**Risk Factors**

A complete listing of our risk factors is contained in the Item 1A. "Risk Factors" section of our Annual Report on Form 10-K for the year ended December 31, 2005. Updates are as follows:

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

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

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

We may become involved in the defense and prosecution, if necessary, of intellectual property suits, patent interferences, opposition proceedings and other administrative proceedings. For example, in March 2006, we prevailed in a patent infringement suit that had been pending against us in federal court in Texas since 2001. Following is a chronology of this lawsuit. On July 24, 2001, Neutrino Development Corporation ("Neutrino") filed a complaint against us in U.S. District Court, Southern District of Texas, Houston Division, alleging infringement of U.S. Patent 6,221,021, or the '021 patent, by SonoSite as a result of our use, sale and manufacture of the SonoSite 180, SonoSite 180PLUS, SonoHeart and SonoHeart Plus devices (the "Original Products"). Subsequently, the SonoHeart ELITE, iLook, TITAN and MicroMaxx systems were also added to the lawsuit (the "New Products"). The complaint asserted claims for preliminary and permanent injunctive relief enjoining all alleged acts of infringement, compensatory and enhanced damages, attorney's fees and costs, and pre- and post-judgment interest.



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In October 2001, Neutrino's motion for preliminary injunction was denied. In February 2002, the district court held a Markman hearing to interpret certain claims in the '021 patent and issued its claim construction in August 2003. In September 2004, the district court granted Neutrino's motion for summary judgment of infringement, finding that SonoSite's Original Products infringe the '021 patent as the district court construed the claims in the Markman hearing. Following this decision, the parties prepared for a jury trial on the issues of infringement by SonoSite's New Products and validity of the '021 patent, filing various motions, including motions for summary judgment. On March 21, 2006, the district court granted SonoSite's motion for summary judgment of patent invalidity based on new matter. The district court found that Neutrino improperly amended the '021 patent in violation of the U.S. patent laws to include a description of a component being handheld which was not disclosed in the original patent application. In a final judgment, the district court declared that the claims being asserted against SonoSite in the '021 patent are invalid for new matter, vacated and set aside its September 2004 ruling on infringement, and dismissed Neutrino's claims and causes of action "with prejudice".

The plaintiff has filed a notice of appeal to the U.S. Court of Appeals for the Federal Circuit in Washington, D.C. Both parties have filed their appellate briefs and oral argument will take place on December 5, 2006. We expect that a decision by the appellate court would not issue until mid-to-late 2007. Our motions to declare the case "exceptional," and to recover our attorneys' fees and costs are pending in the district court. We believe that the appellate court will uphold the district court's decision. If we are not successful in the appeal, and the case is reversed and remanded to the district court for a jury trial, and we are not successful in defending these claims in a jury trial, we could be forced to pay damages related to past product sales, modify or discontinue selling our products or may enter into royalty or licensing agreements for future product sales, which may not be available on terms acceptable to us, if at all, and which could adversely affect our financial condition, results of operations and cash flow. Sales of the allegedly infringing products represent the majority of our revenue.

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

Our involvement in intellectual property claims and litigation could:

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

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

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

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

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





In addition, the expansion of sales channels in the U.S. and overseas may cause short-term disruptions. In May 2006, we commenced integration of a channel partner to provide expanded sales capacity for the U.S. physician office market. During the third quarter of 2006, revenue in the U.S. was lower than expected due to this ongoing sales force transition, as we integrated 18 new sales representatives for the office market and re-deployed our core sales team into the hospital market. We anticipate this channel partner will be fully deployed in the fourth quarter of 2006. In addition, our sales force experienced some turnover. As a result, some sales territories with new sales representatives experienced a decrease in revenue in Q3. Despite our introduction of this channel partner, and our recruitment and training of highly skilled sales personnel, we may not be able generate an increase in revenues from the office market and we may experience a decrease in revenues in the short term due to disruptions to our direct sales force.

## Item 3. Quantitative and Qualitative Disclosures about Market Risk

### Interest rate risk

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

As of September 30, 2006, our portfolio consisted of $40.7 million of interest-bearing debt securities with maturities of less than one year and $7.4 million of interest-bearing debt securities with maturities of more than one year. 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 2006 from a hypothetical 10% increase in market interest rates would not have a material impact on the investment portfolio.

### Foreign currency risk

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

As of September 30, 2006, 56% of our outstanding accounts receivable balance was from international customers, of which 58%, or $13.7 million, was denominated in a currency other than USDs. Total sales for the three months ended September 30, 2006 denominated in a currency other than USDs were $11.1 million, or 27.4% of total consolidated revenues. Total sales for the nine months ended September 30, 2006 denominated in a currency other than USDs were $33.2 million, or 28.4% of total consolidated revenues. The British pound, the euro and the Japanese yen represented the majority of financial transactions executed in a currency not denominated in USDs. We regularly review our receivable positions in foreign countries for any indication that collection may be at risk. In addition, we utilize letters of credit where they are warranted in order to mitigate our collection risk.

We periodically enter into foreign currency forward contracts to reduce the impact of adverse fluctuations on earnings associated with foreign currency exchange rate changes. As of September 30, 2006, we had $26.9 million in notional amount of foreign currency forward contracts. These contracts expire on December 29, 2006 and serve as hedges of a substantial portion of our intercompany balances denominated in a currency other than the USD, but are not designated as hedges for accounting purposes. These foreign currencies primarily include the British pound, the euro and the Japanese yen. A sensitivity analysis of a change in the fair value of these contracts indicates that if the USD weakened by 10% against the applicable foreign currency, the fair value of these contracts would decrease by $2.7 million. Conversely, if the USD strengthened by 10% against the applicable foreign currency, the fair value of these contracts would increase by $2.7 million. Any gains and losses on the fair value of these contracts would be largely mitigated by offsetting losses and gains on the underlying transactions. These offsetting gains and losses are not reflected in the sensitivity analysis above. The fair value loss of these contracts as of September 30, 2006 was $0.1 million. Changes in fair value of our derivative instruments are recorded in our consolidated statements of operations.

**Item 4. Controls and Procedures**

**Evaluation of disclosure controls and procedures**

As of September 30, 2006, our chief executive officer and our chief financial officer have evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the Exchange Act), and they have concluded that our disclosure controls and procedures were effective to ensure that the information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.



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**Changes in internal control over financial reporting**

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

**PART II: OTHER INFORMATION**

**Item 1. Legal Proceedings**

A complete description of our legal proceedings in contained in Item 1. "Legal Proceedings" section of our Form 10-Q for the period ended March 31, 2006.

**Item 5. Other Information**

At its October 24, 2006 meeting, the Compensation Committee of the Board of Directors approved the purchase by the company of new life and disability insurance policies to provide individual coverage for the company's senior executives, including its Named Executive Officers. These benefits are expected to come into effect for each covered individual after January 1, 2007.

**Item 7. Exhibits**

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

| | |
|---|---|
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**SIGNATURE**

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

**SONOSITE, INC.**

(Registrant)

Dated: November 03, 2006

By: /s/ MICHAEL J. SCHUH

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



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