SONOSITE INC
Form 10-K
March 15, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

FORM 10-K

**FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

**[X] Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2006**

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 [X] No [ ]

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 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 or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act) Large accelerated filer [ ] Accelerated filer [X] Non-accelerated filer [ ]

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, 2006 as reported on the Nasdaq National Market, was $631,068,522.

As of February 26, 2007, there were 16,481,891 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 2007, 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.

SONOSITE, INC.
ANNUAL REPORT ON FORM 10-K
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Item 15. Exhibits and Financial Statement Schedules

Trademarks

SonoSite®, the stylized SonoSite logo, iLook®, SonoHeart®, TITAN®, SonoCalc® and MicroMaxx® are all registered trademarks of SonoSite, Inc. 180PLUS□, OnSite□ and Imaging Physical□ are trademarks of SonoSite, Inc. All other brand names, trademarks or service marks referred to in this report are the property of their owners.

PART I

Our disclosure and analysis in this report and in our 2006 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 absenc of these words does not necessarily mean that a statement is not forward-looking. Forward-looking statements are subject to known and unknown risks and uncertainties, and are based on potentially inaccurate assumptions that could cause actual results to differ materially from those expected or implied by the forward-looking statements. You should not unduly rely on these forward-looking statements, which speak only as of the date of this report.

We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosures we make on related subjects in our future quarterly reports on Form 10-Q, current reports on Form 8-K and annual reports on Form 10-K. Also note that we provide a cautionary discussion of risks, uncertainties and possibly inaccurate assumptions relevant to our business under the caption □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 (□HCU□). We specialize in the development of HCU systems for use in a variety of medical specialties in a range of clinical settings. Our proprietary technologies have enabled us to design hand-carried diagnostic 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 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 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, 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 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 thousands of systems worldwide.

We introduced our newest product, the MicroMaxx® system ("MicroMaxx system") in April 2005. 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 began in June 2005 and it accounted for the majority of our revenue in 2006. 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™ and iLook® series. The SonoSite 180PLUS™ system was designed for general ultrasound imaging and the SonoHeart® ELITE is specifically configured for cardiovascular applications. The iLook 25 imaging tool is designed to provide visual guidance for physicians and nurses while performing vascular access procedures and the iLook 15 imaging tool is designed to provide imaging of the chest and abdomen. Our second generation product, the TITAN® system, began shipping in June 2003. This high performance system addresses both traditional and emerging ultrasound markets.

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

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, that physicians use to diagnose, stage and monitor disease states and conditions. Color Doppler technology expands standard ultrasound imaging by generating a colorized image showing the presence and direction of blood flow.

Through the use of software algorithms in the ultrasound system, clinicians can provide a quantitative assessment of anatomical structures and physiological functions such as blood flow velocity and cardiac ejection fraction.

Our Markets

According to estimates by Klein Biomedical Consultants, Inc. (Klein), the worldwide ultrasound market in 2006 was $3.9 billion (excluding upgrades and service). Radiology or general imaging is the largest clinical segment and accounts for 36% of this market. Cardiology and OB/Gyn account for 25% and 23%, respectively. Vascular medicine and other applications account for the remaining 16%. The U.S. market represents 31% of the worldwide market. An important clinical segment within the international market is the shared services market,

which is comprised of systems configured to perform both radiology and cardiology examinations. Based on industry analyst reports, we estimate that this market accounts for 20% of the international market, or $540 million.

In 2003 industry analysts began to separately track the market for HCU. HCU products are defined as laptop-sized systems weighing 12 pounds or less. Worldwide sales of HCU products have grown from $10 million in 1999, when SonoSite began shipping the first HCU products, to estimated sales of $397 million in 2006 with sales approximately evenly divided between U.S. and international markets, according to Klein. Some of the market growth in HCU has and will come at the expense of cart-based systems. Our market focus, and we believe the greatest growth opportunities, will come from new point-of-care clinical applications and new users of ultrasound due to high performance, mobility, durability, ease-of-use and other attributes of our HCU products.

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 private office, as well as into alternate 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 acute and critical care. In the clinic or private practice office setting, 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 surgical settings and the preventive cardiovascular practice. 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 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, 2006, we employed approximately 90 people in research and development. Since our inception in 1998, we have introduced three generations of our hand-carried ASIC technology, which have improved performance and expanded clinical capabilities of our systems. The MicroMaxx system, based on our third generation ASIC technology, provides a scalable technology platform that will enable us to customize future products for specific clinical applications that vary by size, cost and performance.

Maximize the productivity of our direct sales force. As of December 31, 2006, we employed over 100 direct sales representatives in the U.S., the United Kingdom, France, Germany, Spain, Japan, Australia and Canada. 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 corporate account relationships.

Broaden our sales distribution channels; enter into strategic relationships. We believe that other markets offer opportunity for growth, but will require enhancements to our sales distribution channels. For example, we established an alliance with Market Bridge, a sales channel partner, to address the physician office market and we established strategic alliances with Boston Scientific Corporation and Nippon Sherwood Medical Industries Ltd. for distribution of our iLook product in the U.S. and Japan, respectively. We intend to enter into new third party distributor arrangements and explore strategic relationships to develop markets within ultrasound or with ultrasound-dependent technologies. We believe that strategic relationships can accelerate market penetration to customers not served by our direct sales force.

Drive our technology across the clinical spectrum. 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 are expanding the use of ultrasound beyond the imaging center to the patient point-of-care, such as the emergency room, the physician□s office and other non-traditional ultrasound settings. With the addition of our SonoCalc® IMT software, which allows physicians to measure the wall thickness (known as the □IMT□) of the carotid artery, we have taken initial steps to enter the market for cardiovascular disease management. We believe that new markets like these will offer us significant potential for additional growth.

Our Products

We offer four types of HCU systems: the MicroMaxx system, TITAN system, 180 series (180PLUS and SonoHeart ELITE) and the iLook series (iLook 15 and 25). All SonoSite ultrasound systems consist of a digital beamformer, broadband imaging, an integrated color display, a control panel, an alphanumeric keyboard and multiple caliper measurement tools. With the exception of the iLook platform (which supports color power Doppler only), 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 25) provide Tissue Harmonic Imaging capabilities, which use 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 is 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 sell 15 different transducers to use with our systems to address a broad range of clinical applications.

In addition to the above, the MicroMaxx and TITAN systems support dual screen imaging for vascular and small parts 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. Both are 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; the TITAN and MicroMaxx systems are fully functional in all portable exam environments, whether or not connected to the docking station.

The following is a summary of our ultrasound product platforms:

MicroMaxx System. The MicroMaxx system, first shipped in June 2005, weighs 7.7 pounds (with battery) and is a high performance, hand-carried ultrasound system. It has 13 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. The MicroMaxx system may be upgraded to new software features through a standard flashcard or interchangeable hardware.

SonoSite TITAN. The TITAN system, first shipped in June 2003, weighs 7.5 pounds. Like the MicroMaxx system, the TITAN system features a larger display screen than the 180 or iLook products and has removable

memory flashcards for enhanced image or study storage. The TITAN system may be upgraded to new software features through a standard flashcard or interchangeable hardware.

SonoSite 180 Series (includes SonoSite 180PLUS and SonoHeart Elite). The SonoSite 180PLUS system weighs 5.4 pounds and is a point-of-care ultrasound system for general diagnostic and procedural assistance imaging. It was our initial product that created the hand-carried ultrasound category. The SonoHeart ELITE system is a point-of-care ultrasound system with expanded measurement tools and clinical analysis packages intended for use by cardiologists and other healthcare providers in the cardiology or bedside assessment market. The SonoHeart ELITE has all the product features of the SonoSite 180PLUS.

iLook Series. The iLook series consists of the iLook 15 and 25, each weighing approximately 3 pounds. The iLook 15 tool, with its fixed curved array transducer, provides imaging for focused abdominal and cardiac applications. The iLook 25 tool, with its fixed linear transducer, enables the clinician to visualize a patient's vessels to aid in vascular access applications.

We also offer the following software, accessories and educational programs:

- *SonoCalc IMT Software.* Patented, automatic edge-detection software provides physicians with the ability to measure the intima media thickness of a patient's carotid artery and compare it with published population data to generate an individualized cardiovascular report.

- *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 also 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. 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.

Sales and Marketing

We currently sell our products through sales channels comprised of direct sales representatives, clinical application specialists and their managers, independent third-party distributors managed by distribution managers, and strategic alliances. In May 2006, we commenced integration of Market Bridge, a new channel partner, to expand our sales in the U.S. physician office market. As of December 31, 2006, we employed over 100 direct sales representatives in the U.S. and in our wholly-owned subsidiaries located in the United Kingdom, Germany, France, Spain, Japan, Australia and Canada. In addition to our direct sales, we sell products in over 90 countries through a network of independent third-party distributors. In addition, we employ regional distribution managers responsible for Middle East and Africa, Europe, Latin America, China, India and Asia.

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., Premier, Inc., Novation LLC, MedAssets HSCA, Inc., Consorta, Inc., and Broadlane, Inc. (includes Kaiser Permanente, Tenet Healthcare and others). We also have two supply agreements with the U.S. government, specifically with the Defense Supply Center of Philadelphia and the General Services 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 52% of our revenue from domestic sales in 2006 compared to 54% in 2005 and 53% in 2004. We attribute revenue to a foreign country based on the location to which we ship our products. However, 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 product inventory to new distributors. We currently have one reporting segment. For information regarding revenues and long-lived assets by geography, refer to Note 13 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, file patent applications to protect our technology. We hold 21 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 23 foreign patents relating to our products, and we currently have 34 patent applications pending in the U.S. and 49 pending registrations abroad.

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 and copyrighted software 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 December 2006, a favorable judgment from a Federal U.S. District Court in Texas was affirmed at the appellate level in a patent infringement suit that had been pending against us 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, attorneys fees and costs, and pre- and post-judgment interest. On September 30, 2004, the Texas court ruled that SonoSites products infringed the 021 patent claims as previously construed by the court.

On March 21, 2006, the district court granted SonoSites 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 portable and sized to be 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 Neutrinos claims and causes of action with prejudice.

The plaintiff filed a notice of appeal to the U.S. Court of Appeals for the Federal Circuit in Washington, D.C. and oral argument on the appeal took place on December 5, 2006. On December 8, 2006, the Court of Appeals

unanimously affirmed the Texas court's summary judgment of invalidity in favor of SonoSite, and relied on the District Court's opinion instead of writing a new one. On December 15, 2006, Neutrino filed a motion for a panel rehearing and a motion for a rehearing en banc. The Court of Appeals denied both motions on January 19, 2007. On January 24, 2007, Neutrino filed a notice with the Texas district court of its intent to file a Petition of Certiorari to the U.S. Supreme Court. We have not yet seen the petition. Our motions to declare the case "exceptional," and to recover our attorneys' fees and costs are pending in the Texas district court.

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 this 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, Philips, Biosound Esaote, Inc., Medison America Inc., a subsidiary of Medison Company, Ltd. ("Medison America"), Terason, a division of TeraTech Corporation ("Terason"), and Zonare Medical Systems, Inc., a privately held company ("Zonare").

Research and Development and Technology

We currently employ approximately 90 people in research and development. In 2006, 2005 and 2004, expenses attributable to research and development for our business totaled $20.2 million, $15.2 million and $12.6 million. We believe our products represent the most advanced 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 create 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.

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 approximately two to 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 ISO quality system has been developed by the International Organization for Standardization to ensure that companies are aware of the standards of quality to which their products will be held worldwide. While no additional pre-market approvals in individual European Union countries are required prior to marketing a device bearing the CE marking, practical complications with respect to marketing introduction may occur. For example, differences among countries have arisen with regard to labeling requirements. We may not be successful in maintaining certification requirements necessary for distribution of our products in the European Union and failure to maintain the CE marking will preclude us from selling our products there.

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

Reimbursement

In the U.S., the Center for Medicare and Medicaid Services (□CMS□), establishes guidelines for the reimbursement of healthcare providers treating Medicare and Medicaid patients. Under current CMS guidelines, varying reimbursement levels have been established for ultrasound imaging and diagnostic procedures performed by our products. The actual reimbursement amounts are determined by individual state Medicare carriers and by private insurance carriers for non-Medicare and Medicaid patients. Moreover, states as well as private insurance carriers may choose not to follow the CMS reimbursement guidelines. The use of our products outside the U.S. is similarly affected by reimbursement policies adopted by foreign regulatory agencies and insurance carriers.

Service and Warranty

Our typical warranty period is one year except for the MicroMaxx system, which has, with certain exceptions, a five-year warranty period. 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):

	Balance at beginning of year	Charged to cost of revenue	Applied to liability	Balance at end of year
Year ended December 31, 2006	$995	$ 2,397	$ (1,074)	$ 2,318
Year ended December 31, 2005	$561	$ 1,049	$ (615)	$ 995
Year ended December 31, 2004	$381	$ 709	$ (529)	$ 561

Employees

As of December 31, 2006, we had approximately 550 employees, of which approximately 17% were engaged in product research and development, 21% in manufacturing, 47% in sales and marketing activities and the remaining 15% in administrative capacities, including executive, finance, legal, human resources, regulatory and information services and technology. Of these, approximately 400 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 "About SonoSite" then "For 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 success depends on new product development.

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

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

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

Our 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 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.

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

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

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

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

We currently face competition from companies that manufacture cart-based and portable ultrasound systems. The dominant competitors in this industry are GE Healthcare, Siemens, and Philips. These competitors are very large, global organizations and have the following 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 increase and withstand competition through various means, including price and payment terms, marketing strategies that bundle the sale of portable systems with other medical products, technological innovation, market penetration, employee compensation, hospital systems integration and complementary services such as warranty protection, maintenance and product training. Existing product supply relationships between these competitors and our potential customers could discourage widespread adoption of our products due to brand loyalty or preferred customer discounts. Competition from these companies for employees with experience in the primary point-of-care market could result in higher turnover of our employees. If we are unable to respond to competitive pressures within the cart-based and HCU markets, we could experience delayed or reduced market acceptance of our products, higher expenses and lower revenue.

In addition, as the market for high-performance HCU develops, we expect competition to increase as potential and existing competitors enter the portable market or modify their existing products to more closely approximate the combined portability, quality, performance and cost of our products. Our current competitors in the portable market include Siemens, GE Healthcare, Philips, Biosound Esaote, Inc., Medison America, Terason, and Zonare. These competitors may develop highly portable or point-of-care ultrasound systems that offer the same or greater reliability and quality, perform greater or more useful functions or are more cost-effective than our products. Some of these competitors may also be able to use their marketing resources to gain a competitive advantage by more effectively building brand awareness of their products. If we are unable to compete effectively with current or new entrants to the high-performance, HCU market, we will be unable to generate sufficient revenue to maintain our business.

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

We do not generally have long-term or volume purchase commitments with our customers, who typically order products on a purchase order basis. In limited circumstances, customer orders may be cancelled, changed or delayed on short notice. Lack of significant order backlog makes it difficult for us to forecast future sales with certainty. Varying sales cycles with our customers make it difficult to accurately forecast component and product

requirements. These factors expose us to a number of risks:

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

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

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

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

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

If we experience difficulties in manufacturing, we may fail to meet our 2007 revenue projections or we may incur greater than expected warranty expense.

The final assembly and testing of our products is done at our Bothell, Washington facility incorporating components manufactured by various suppliers. If we encounter supplier, regulatory, engineering or technical difficulties in manufacturing, we may incur delays in delivery of these products to customers that could adversely affect our revenues for 2007 and beyond.

We expect our warranty liability and expense to continue to increase significantly due to the five-year warranty offered with the MicroMaxx system. Should actual failure rates and repair or replacement costs differ from our estimates, additional warranty expense may be incurred and our results may be materially affected.

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

Trends toward managed care, healthcare cost containment, and other changes in government and private sector initiatives in the U.S. and other countries in which we do business are placing increased emphasis on the delivery of more cost-effective medical therapies, which could adversely affect the sale and/or the prices of our

products. For example:

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

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

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

Market acceptance of our products depends in part on the extent to which our customers receive reimbursement for the use of our products from third party payers such as Medicare, Medicaid and private health insurers (and equivalent third party payers in foreign countries). Presently, reimbursement policies for physician-performed diagnostic imaging services are fairly unrestricted in the U.S. The continuing efforts of governmental authorities, private health insurers and other third party payers to contain or reduce the costs of healthcare through various means could, however, result in more restricted payment policies for diagnostic imaging. As an example, a Medicare payment policy arising from the Deficit Reduction Act of 2005, effective January 1, 2007, caps payments to physician offices and freestanding imaging centers for the technical component of most imaging services. Although reimbursement amounts for most ultrasound procedures were not lowered by this payment policy, vascular ultrasound examinations and ultrasound guidance of needle procedures, such as biopsies, aspirations and injections are now being paid at a lower rate than they were previously. We have not yet seen any impact of these changes on demand for our products. We expect that, as providers become more aware of the reduced payments for those select services, demand will not diminish for our products in existing markets where clinical practice patterns are already well established. However, in markets in which the use of ultrasound is an emerging standard of care, the enactment of this provision has created short-term uncertainty, which may dampen demand for ultrasound equipment.

Additionally, some private insurers have implemented imaging privileging programs as a means of controlling utilization of imaging services. For example, Highmark Blue Cross Blue Shield, a private insurer operating in Pennsylvania, requires that providers meet specific criteria in order to receive payment for imaging services provided to its subscribers. These criteria, in some instances, exclude some providers by virtue of their clinical specialty. Other criteria require providers to obtain specific credentials from third party accreditation organizations. As another example, United Healthcare recently announced that providers of echocardiography must be accredited by the American College of Radiology or the Intersocietal Accreditation Commission by March of 2008 in order to continue to receive payment for the provision of these services to their subscribers. In this case, because the policy covers only a limited number of ultrasound services (general ultrasound and non-invasive vascular scanning are not included), the impact of this policy on our business is likely to be limited.

In response to rising healthcare costs and the perception that new technologies are a significant contributing factor to the growth in healthcare costs, third party payers are demanding ever higher levels of evidence of clinical efficacy and cost effectiveness in order to provide coverage for new procedures.

Third party payers, both governmental and private, are calling for increasing levels of evidence of beneficial clinical outcomes and cost effectiveness in addition to proof of clinical efficacy as a prerequisite to granting coverage for new technologies and devices and new applications of existing technologies. Thus, to the extent that services performed with current or future products that we may bring to market are not described by existing Current Procedural Terminology codes or are not covered under existing coverage policies, there is a risk that reimbursement for these applications may not be attained at all or within a reasonable timeframe. For example, carotid intima media thickness measurement, which is an application of ultrasound performed by our SonoCalc IMT software, is not currently reimbursed by Medicare and is not a part of third party payers standard benefits packages.

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. On February 21, 2007, we filed a patent infringement suit against Zonare Medical Systems, Inc. alleging that Zonare infringed one of our key patents through sales of its z.one ultrasound system. On March 14, 2007, Zonare filed an answer to our claim which included a counterclaim against the company alleging that our products infringe its patent related to its portable docking station. 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, since July 24, 2001, we have been defending a patent infringement suit, Neutrino Development Corporation vs. SonoSite, in the U.S. District Court for the Southern District of Texas. This case has generated significant legal expenses, diverted management and engineering resources and exposed the company to potentially large liabilities. As described in the section entitled Patent and Intellectual Property Rights, the Court of Appeals for the Federal Circuit recently affirmed the lower courts ruling in SonoSites favor in this case, but the plaintiff has indicated his intention to file a petition for a writ of certiorari to the Supreme Court.

In summary, involvement in intellectual property claims and litigation could have the following adverse consequences:

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

The percentage of our revenue originating outside the U.S. equaled 48%, 46% and 47% for the years ended December 31, 2006, 2005 and 2004. Total sales for the year ended December 31, 2006 denominated in a currency other than U.S. dollars (USDs) were $49.0 million, or 29% of total consolidated revenues. Our revenue from international sales may be adversely affected by any of the following risks:

- currency rate fluctuations;
- adverse political or economic conditions;
- reduced protection for intellectual property rights;
- difficulty managing and overseeing international employees from the U.S.;
- difficulty enforcing company policies and internal controls in international operations;
- longer receivables collection periods and greater difficulty in receivables collection;
- localizing products for foreign markets; and
- compliance with export laws, including license requirements, trade restrictions and tariff increases.

As of December 31, 2006, 56% of our outstanding accounts receivable balance was from international customers, of which 55%, or $16.2 million, was denominated in a currency other than USDs. We regularly review our receivable positions in foreign countries for any indication that collection may be at risk.

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

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

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

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

Under Section 404 of the Sarbanes-Oxley Act of 2002, we are required to evaluate and determine the effectiveness of our internal controls over financial reporting. We dedicated a significant amount of time and resources to ensure compliance with this legislation for the year December 31, 2006 and will continue to do so for future fiscal periods. We may encounter problems or delays in completing the review and evaluation, the implementation of improvements and the receipt of a positive attestation, or any attestation at all, by our independent auditors. Additionally, management's assessment of our internal controls over financial reporting may identify deficiencies that need to be addressed in our internal controls over financial reporting or other matters that may raise concerns for investors.

As a part of the annual audit of our internal controls over financial reporting and our consolidated financial statements for the year ended December 31, 2006, we identified a material weakness regarding the level of resources and expertise for preparation and review of our tax provision. As of December 31, 2006, we did not

have the appropriate level of expertise to properly prepare and review our accounting for income taxes. As a result of this deficiency in our internal control over financial reporting, we did not detect errors in the measurement of income tax amounts as of and for the year ended December 31, 2006. Because of this material weakness, our management concluded that, as of December 31, 2006, we did not maintain effective internal control over financial reporting based on those criteria. As a result, KPMG LLP has issued an adverse opinion with respect to our internal controls over financial reporting and their report is included in this Form 10-K.

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

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

We have incurred net losses in each fiscal year since we commenced operations, with the exception of $7.2 million, $5.4 million and $23.0 million of net income reported during the years ended December 31, 2006, 2005 and 2004. As of December 31, 2006, we had an accumulated deficit of $51.8 million. We may be unable to sustain or increase future profitability on a quarterly or annual basis. Although we expect to achieve profitability in future periods, we may incur losses if we cannot increase or sustain our revenue. We expect that our operating expenses will increase in the foreseeable future as we expand our product development activities, our sales and marketing infrastructure, our administrative support and our product offerings. Our expansion efforts, to be successful, may require more funding than we currently anticipate.

Accordingly, we will need to generate significant additional revenue in the future before we will be able to sustain or increase profitability. If we cannot generate such revenue, we may not be profitable. If we fail to achieve sustained profitability, the market price for our common stock will likely fall.

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

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

In addition, our circuit boards are produced by one of the world□s largest electronic manufacturing services suppliers who produce the boards in their Thailand manufacturing facility. If we experience delays in the receipt or deterioration in product yields of these components, we may experience delays in manufacturing or an increase in costs resulting in lost sales or a deterioration in gross margin.

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

We have experienced rapid growth since our inception as a stand-alone company in 1998. Our revenue increased to $171.1 million in 2006 from $147.5 million in 2005 and $115.8 million in 2004. We expect continued significant growth as we continue to develop, manufacture, market and sell our products. Our growth could strain our existing management, operational and financial resources. In order to manage our growth effectively, we will need to expand our manufacturing and quality assurance staff, our sales staff and our international support staff. In addition, we will need to improve the productivity and efficiency of our existing operational, financial and management resources and information systems. Any problems in successfully completing this upgrade may

impact our operations and perhaps our financial results. We may be unable to hire and retain the personnel necessary to operate and expand our business. We also may be unable to increase the productivity and efficiency of our existing resources. If we fail to timely improve or augment our existing resources in response to our growth, we may be unable to effectively manage our business and achieve our objectives.

Our consolidated effective income tax rate will fluctuate depending upon the mix of our U.S. operations and our international operations. Additionally, utilization of our deferred tax assets may be limited and is dependent on future taxable income.

In the fourth quarter of 2004, deferred tax assets relating to our U.S. operations were recognized on our balance sheet resulting in a non-recurring income tax benefit. Prior to this time, we provided a full valuation allowance against our deferred tax assets. The deferred tax assets primarily represent the income tax benefit of U.S. NOLs we have incurred since inception. As required by Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes," ("SFAS 109"), we did not recognize any tax assets on our balance sheet until it was "more likely than not" that the tax assets related to our U.S. operations would be realized on future tax returns. Based upon a review of historical operating performance through 2006, and our expectation that we will generate U.S. profitability for the foreseeable future, we continue to believe it is more likely than not that the U.S. deferred tax assets will be fully realized. In the fourth quarter of 2006, we reversed our valuation allowances against our deferred tax assets resulting from our international operations because we have demonstrated their profitability and our expectation is that they will generate profitability for the foreseeable future. The amount of foreign deferred tax assets recorded in 2006 was limited to the amount we believe is probable of being sustained under audit by foreign taxing authorities and excluded deferred tax assets that are uncertain of being realized. Until it is more likely than not that the remaining tax assets will be realized in future tax returns, we will not further record any tax assets related to our international operations. As a result of these factors and uncertainties, our consolidated effective income tax rate may continue to fluctuate.

We re-evaluate our ability to utilize our NOL and tax credit carryforwards in future periods and, in compliance with SFAS 109, record any resulting adjustments that may be required to deferred income tax expense. The Tax Reform Act of 1986 contains provisions under section 382 of the Internal Revenue Code that limit the federal NOL carryforwards that may be used in any given year in the event of specified occurrences, including significant ownership changes. If these specified events occur, we may lose some or all of the tax benefits of these carryforwards. In addition, we will reduce the deferred income tax asset for the benefits of NOL and tax credit carryforwards actually used in future quarters. Therefore, if we generate profits, we will record the related income tax expense for financial reporting purposes based on a blended federal, state and foreign rate applied to income by jurisdiction. While this tax expense will reduce net income, no cash will be paid for income taxes, other than required alternative minimum tax, state and foreign tax payments, until the NOL and tax credits have been fully utilized. If in the future we determine, based on our assessment of both positive and negative evidence and objective and subjective evidence, which takes into consideration our forecasted taxable income, that it is more likely than not that we will not realize all or a portion of the deferred tax assets, we will increase the valuation allowance against deferred tax assets which would result in a charge to income tax expense.

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

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

In addition, disagreements with our distributors or nonperformance by distributors could lead to costly and time-consuming litigation or arbitration and disrupt distribution channels for a period of time and require us to re-establish a distribution channel. For example, in May 2005, we arbitrated a dispute with our former distributor in the veterinary market in which the arbitration panel unanimously found in our favor.

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

Our success depends heavily on our ability to retain the services of certain key employees. Competition among medical device companies for qualified employees is intense. We may fail to retain these key employees, and we may fail to attract qualified replacements if they do leave. We do not maintain key-person insurance on any of our employees. We do not have employment agreements with any of our employees except for employees in certain countries outside the U.S. 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.

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

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

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 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.

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

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

We currently hold 44 patents relating to our technology. A number of other patents are pending in the U.S. and in foreign jurisdictions. Additionally, we have a license from ATL to use certain ATL technology and ATL technological developments in our hand-carried products. This license was exclusive through April 5, 2003, and

became nonexclusive after that date. We also enter into confidentiality and invention ownership agreements with our employees, consultants and corporate partners, and generally control access to, and the distribution of, our product designs, documentation and other proprietary information, as well as the designs, documentation and other information that we license from others.

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

- unauthorized use of our technology by competitors;
- independent development of the same or similar technology by a competitor, coupled with a lack of enforceable patents on our part;
- failure of our pending patent applications to result in issued patents;

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

Policing unauthorized use of our intellectual property will be difficult and may be cost-prohibitive. We may fail to prevent misappropriation of our technology, particularly in countries where the laws may not protect our proprietary rights to the same extent as do the laws of the U.S. 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.

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

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

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

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

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

could significantly impair our financial condition. In addition, a product field action or a liability claim against us could significantly harm our reputation and make it more difficult to obtain the funding and commercial relationships necessary to maintain our business.

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

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

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

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

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

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

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

As of December 31, 2006, our executive officers, directors and affiliated entities together beneficially owned 5.6% of the outstanding shares of our common stock. Based on currently available information, fourteen other shareholders owned in the aggregate 49.3% of the outstanding shares of our common stock. As a result, these shareholders or any other concentrated owner may be able to exert significant influence over all matters requiring shareholder approval, including the election of directors, matters relating to the attraction and retention of employees, such as stock option plans, and approval of significant corporate transactions that could include certain matters relating to future financing arrangements and unsolicited tender offers. This concentration of ownership may delay, deter or prevent a third party from acquiring control over us at a premium over the then-current market price of our common stock, which could result in a decline in our stock price.

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

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

incorporating this ATL technology.

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

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

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

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

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

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

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

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 each subsidiary location.

ITEM 3. LEGAL PROCEEDINGS

In December 2006, a favorable judgment from a Federal U.S. District Court in Texas was affirmed at the appellate level in a patent infringement suit that had been pending against us 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, attorneys fees and costs, and pre- and post-judgment interest. On September 30, 2004, the Texas court ruled that SonoSites products infringed the 021 patent claims as previously construed by the court.

On March 21, 2006, the district court granted SonoSites 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 portable and sized to be 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 Neutrinos claims and causes of action with prejudice.

The plaintiff filed a notice of appeal to the U.S. Court of Appeals for the Federal Circuit in Washington, D.C. and oral argument on the appeal took place on December 5, 2006. On December 8, 2006, the Court of Appeals unanimously affirmed the Texas courts summary judgment of invalidity in favor of SonoSite, and relied on the District Courts opinion instead of writing a new one. On December 15, 2006, Neutrino filed a motion for a panel rehearing and a motion for a rehearing en banc. The Court of Appeals denied both motions on January 19, 2007. On January 24, 2007, Neutrino filed a notice with the Texas district court of its intent to file a Petition of Certiorari to the U.S. Supreme Court. We have not yet seen the petition. Our motions to declare the case exceptional, and to recover our attorneys fees and costs are pending in the Texas district court.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our shareholders during the fourth quarter of the year ended December 31, 2006.

PART II

ITEM 5. MARKET FOR REGISTRANTS 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
2006		
Fourth quarter	$34.08	$27.22
Third quarter	$40.22	$26.56
Second quarter	$41.37	$34.20
First quarter	$42.14	$33.64
2005		
Fourth quarter	$39.78	$26.96
Third quarter	$37.10	$28.90
Second quarter	$33.46	$24.44
First quarter	$34.98	$23.36

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 2006.

Sales of Unregistered Securities

There were no sales of unregistered securities by SonoSite in 2006.

Holders

As of February 26, 2007, there were 2,877 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.

Performance Graph

The following performance graph compares the performance of SonoSite□s common stock during the five-year period from December 31, 2002 through December 31, 2006 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.

Comparison of Cumulative Total Return
December 31, 2002 to December 31, 2006
SonoSite, Inc vs. Published Indices

	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
SonoSite, Inc.	$ 100.00	$ 164.42	$ 259.76	$ 267.87	$ 236.65
Nasdaq National Market, U.S. Index	$ 100.00	$ 149.83	$ 162.93	$ 166.39	$ 180.36
Nasdaq Medical Devices, Instruments and Supplies, Manufacturers and Distributors Stocks Index	$ 100.00	$ 147.77	$ 173.15	$ 190.21	$ 200.62

ITEM 6. SELECTED FINANCIAL DATA

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

	For the Years Ended December 31,				
	2006	2005	2004	2003	2002
	(in thousands, except per share data)				
Statement of Operations Data					
Revenue	$171,083	$147,491	$ 115,817	$84,770	$73,035
Cost of revenue	49,673	43,652	37,755	30,918	29,800
Gross margin	121,410	103,839	78,062	53,852	43,235
Operating expenses:					
Research and development	20,183	15,195	12,644	11,179	12,126
Sales and marketing	81,631	68,090	51,824	38,474	33,555
General and administrative	15,760	13,662	10,296	7,315	5,983
Total operating expenses	117,574	96,947	74,764	56,968	51,664
Other income (loss):					
Interest income	3,683	1,753	963	965	958
Interest expense	—	(2)	—	(23)	(36)
Other income (loss)	294	(795)	(601)	390	(224)
Total other income	3,977	956	362	1,332	698
Income (loss) before income taxes	7,813	7,848	3,660	(1,784)	(7,731)
Income tax (provision) benefit	(582)	(2,412)	19,312	—	—
Net income (loss)	$ 7,231	$ 5,436	$ 22,972	$ (1,784)	$ (7,731)
Net income (loss) per share:					
Basic	$ 0.44	$ 0.35	$ 1.55	$ (0.12)	$ (0.59)
Diluted	$ 0.43	$ 0.34	$ 1.46	$ (0.12)	$ (0.59)
Shares used in computing net income (loss) per share:					
Basic	16,274	15,549	14,829	14,335	13,075
Diluted	16,857	16,175	15,737	14,335	13,075

	As of December 31,				
	2006	2005	2004	2003	2002
	(in thousands)				
Balance Sheet Data					
Cash and cash equivalents	$ 45,673	$ 26,809	$ 17,272	$ 13,683	$ 26,381
Working capital	148,408	104,999	69,370	54,809	56,705
Total assets	211,510	174,548	155,092	109,090	105,877

Long-term obligations, less current portion					88
Total shareholders equity	181,031	152,042	133,235	95,330	92,614

ITEM 7. MANAGEMENTS DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 in a range of clinical settings. Our proprietary technologies have enabled us to design hand-carried diagnostic 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 patients bedside or the physicians 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 hospitals 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, 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 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 base of thousands of systems worldwide.

We introduced our newest product, the MicroMaxx® system (MicroMaxx system) in April 2005. 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 began in June 2005 and it accounted for the majority of our revenue in 2006. 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 and iLook® series. The SonoSite 180PLUS system was designed for general ultrasound imaging and the SonoHeart® ELITE is specifically configured for cardiovascular applications. The iLook 25 imaging tool is designed to provide visual guidance for physicians and nurses while performing vascular access procedures and the iLook 15 imaging tool is designed to provide imaging of the chest and abdomen. Our second generation product, the TITAN® system, began shipping in June 2003. This high performance system addresses both traditional and emerging ultrasound markets.

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 U.S. generally accepted accounting principles. 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.

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.

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

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

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

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

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

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

Goodwill. Goodwill represents the excess of cost over the estimated fair value of net assets acquired in connection with our acquisition of SonoMetric Health, Inc. (SonoMetric) in 2004. We test goodwill for impairment on an annual basis, or more frequently if circumstances dictate, for each reporting unit identified for purposes of accounting for goodwill. A reporting unit is an operating segment or one level below an operating segment (referred to as a component). A component is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component. There is no discrete financial information available for SonoMetric because it was incorporated into SonoSite immediately after acquisition. Therefore, SonoSite is the reporting unit to which goodwill resulting from the SonoMetric acquisition is assigned.

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

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

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

Warranty expense. We accrue estimated warranty expense at the time of sale for costs expected to be incurred under our product warranties. This provision for warranty expense is made based upon our historical product failure rates and service repair costs using management's judgment. We have limited history with some of our products. In addition, we provide, with certain exceptions, a five-year warranty with the MicroMaxx system, which we began shipping in June 2005. Given the length of the warranty period, the warranty liability for the MicroMaxx system is more difficult to estimate than it has been for our other products that have a one-year warranty. However, given the similarity of the components used in the MicroMaxx system compared with our other systems and the historical product failure rate and service repair costs of those other systems, we believe that we can reasonably estimate the amount of the warranty liability for this product. We expect our warranty liability and expense to continue to increase significantly due to the five-year warranty offered with this product. Should actual failure rates and repair or replacement costs for any of our products differ from estimates, revisions to the estimated warranty liability may be required and our results may be materially affected.

Income taxes. As part of the process of preparing our consolidated financial statements, we are required to determine our income taxes. This process 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 do not meet the test that recovery is more likely than not, we establish a valuation allowance. To the extent that we establish a valuation allowance or change this allowance in a period, we adjust our tax provision or tax benefit in the consolidated statement of operations. We use our judgment to determine our provision or benefit for income taxes, and any valuation allowance recorded against our deferred tax assets based on the weight of all positive and negative factors, including cumulative trends in profitability.

We have accumulated U.S. federal and state income tax NOL carryforwards, foreign NOL carryforwards and research and experimentation tax credit carryforwards. Deferred tax assets were recognized on our balance sheet in the fourth quarter of 2004 resulting in an income tax benefit. Prior to this time, we provided a full valuation allowance against our deferred tax assets. The deferred tax assets primarily represent the income tax benefit of U.S. NOLs we have incurred. In the fourth quarter of 2006, we recognized a deferred tax asset on our

balance sheet representing NOLs from our international operations. As required by SFAS 109, we did not recognize any tax assets on our balance sheet until it was more likely than not that the tax assets related to either our U.S. or international operations would be realized. We re-evaluate our ability to utilize our NOL and tax credit carryforwards in future periods and, in compliance with SFAS 109, record any resulting adjustments that may be required to deferred income tax expense. In addition, we reduce the deferred income tax asset for the benefits of NOL and tax credit carryforwards actually used in future periods. 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 through 2006, and our expectation that we will generate profits in the U.S. and those 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.

Stock-Based Compensation. On January 1, 2006, we adopted the fair value recognition provisions of FASB Statement No. 123R, Share-Based Payment (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 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 cash provided by financing activities, rather than as an operating cash flow on a prospective basis, and therefore reduces cash provided by operating activities and increases cash provided by financing activities. This amount is shown as Excess tax benefit from exercise of stock options on our consolidated statement of cash flows. We have adopted the long-haul method to calculate the historical pool of windfall tax benefits, under which we calculate on a grant by grant basis the windfall or excess tax benefit that arose upon exercise of each award based on a comparison to the total tax deduction to the as-if deferred tax asset that would have been recorded had we followed the recognition provisions of SFAS 123 since its effective date. 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 has been previously reported.

Prior to adoption of SFAS 123R, we accounted for stock option grants under the intrinsic value method in accordance with the provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees. 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.

Results of Operations

Revenue

Revenue increased to $171.1 million in 2006, compared to $147.5 million in 2005 and $115.8 million in 2004. The increase in 2006 compared to 2005 was due to a full year of sales of the MicroMaxx system, which has a higher average selling price, expanded international operations, and increased direct sales to hospitals. The increase in 2005 compared to 2004 was primarily due to the introduction of the MicroMaxx system in June 2005 and project orders from governmental entities.

United States

U.S. revenue increased to $89.7 million in 2006, compared to $79.8 million in 2005 and $61.3 million in 2004. The increase in 2006 compared to 2005 was primarily attributable to increased direct sales to hospitals, offset by a decrease in U.S. government sales due to a large order in the first quarter of 2005 and the integration of our

sales channel partner addressing the physician office market. The increase in 2005 compared to 2004 was due to changes in our product mix as well as increased direct, U.S. government and distributor sales and increased average selling price due to MicroMaxx introduction.

International

Revenue from Europe, Africa and the Middle East increased to $48.9 million in 2006, compared to $41.2 million in 2005 and $35.0 million in 2004. The increase in 2006 compared to 2005 was primarily due to increased sales in our direct subsidiaries in Europe, offset by decreased sales to our distributor in Italy. Changes in exchange rates had minimal impact on revenue in 2006.

The increase in 2005 compared to 2004 was primarily due to an increase in sales to our distributors in Europe and India, and an increase in revenue from direct sales in France and Spain that was partially offset by decreases in direct sales to Germany. Changes in exchange rates had minimal impact on revenue in 2005.

Revenue from Canada, Latin and South America and Asia Pacific (excluding Japan) increased to $19.9 million in 2006 compared to $14.5 million in 2005 and $9.8 million in 2004. The increase in 2006 compared to 2005 was due to increased direct sales in Canada and Australia and increased sales to our distributors in Latin and South America. The increase in 2005 compared to 2004 was primarily due to an increase in sales to our distributors in Latin and South America, large government sales in South America and an increase in direct sales in Australia and Canada.

Revenue from Japan increased to $12.6 million in 2006 compared to $11.9 million in 2005 and $9.7 million in 2004. The increase in 2006 compared to 2005 was primarily due to distribution sales through our new distributor, Fukuda Denshi. The increase in 2005 was primarily due to sales under a new exclusive TITAN distribution arrangement and initial sales under our exclusive iLook system distribution arrangement with our distributor, Nippon Sherwood Medical Industries.

We anticipate that revenue will increase in 2007 compared to 2006 due to the continued expansion of our selling efforts worldwide. We expect strong growth from the U.S. physicians office market as we continue to develop this channel, strong growth from the newly expanded international operations such as China, India, Australia and Canada, introduction of new products and features, and the overall expansion of market awareness and acceptance of our products. The expansion of new sales operations may not be as successful as anticipated and we may encounter regulatory and other issues in selling our products. 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 our anticipated growth in revenue. We currently face competition from larger companies that manufacture cart-based and portable ultrasound systems and have greater financial and other resources.

Gross margin

Gross margin increased to 71% in 2006 compared to 70% in 2005 and 67% in 2004. The increase in 2006 compared to 2005 was a result of increased sales of MicroMaxx systems which generate a higher margin than our earlier generation products. The increase in 2005 compared to 2004 was primarily due to an improved product mix, improved manufacturing efficiencies and a reduction in the royalty owed to ATL, which became effective in September 2004.

We expect our gross margin percentage in 2007 to remain consistent with 2006. 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; 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. 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 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 increased to $20.2 million in 2006 compared to $15.2 million in 2005 and $12.6 million in 2004. The increase in 2006 compared to 2005 was primarily due to increased stock-based compensation expenses and increased headcount to support further development of our ASIC technology and the MicroMaxx system. The increase in 2005 compared to 2004 was primarily due to expenses associated with the development and enhancements to the MicroMaxx system, which began shipping in June 2005.

We anticipate that research and development expenses will increase in 2007 compared to 2006 due to continued development of new products, as well as further development related to the MicroMaxx system. However, should our competitors develop products with features that equal or exceed the features that exist in our products, we may incur higher than anticipated research and development costs in order to accelerate existing programs and compete more effectively.

Sales and marketing expenses increased to $81.6 million in 2006 compared to $68.1 million in 2005 and $51.8 million in 2004. The increase in 2006 compared to 2005 was attributable to increased stock-based compensation, expansion of our sales channel partner into the physician□s office market and international sales operations, increased education and training efforts and commissions related to the increase in revenue. The increase in 2005 compared to 2004 was primarily due to increased compensation for commissions related to the increase in revenue, marketing costs incurred to promote the MicroMaxx system, and expansion of our international operations.

We anticipate that sales and marketing expenses will increase in 2007 compared to 2006 primarily due to marketing expenses for education and training, increased compensation for commissions related to the anticipated increase in revenues, expansion of operations in China, India, Canada and Australia and continued growth in our European subsidiaries.

General and administrative expenses increased to $15.8 million in 2006 compared to $13.7 million in 2005 and $10.3 million in 2004. The increase in 2006 compared to 2005 was attributable to increased stock-based compensation and increased headcount to support business growth, offset by a reduction in legal expenses. The increase in 2005 compared to 2004 was primarily due to defending our patent rights in the existing Neutrino patent infringement litigation, defending ourselves in a dispute with a former distributor and supporting our business growth.

We anticipate that general and administrative expenses will slightly increase in 2007 compared to 2006. In addition, we may incur legal expenses regarding our ongoing litigation or unanticipated legal expenses if we become involved in any new litigation.

Other income (loss)

Total other income was $4.0 million in 2006, compared to $1.0 million in 2005 and $0.4 million in 2004. The increase in 2006 compared to 2005 was primarily due to an increase in interest income, which was attributable to our increasing cash reserves. The increase in 2005 compared to 2004 was primarily due to an increase in interest income, which was caused by an increase in the return on our investments due to higher average interest rates during the year.

Income tax expense

Income tax expense was $0.6 million in 2006, compared to income tax expense of $2.4 million in 2005 and an income tax benefit of $19.3 million in 2004. Due to our profitable operations in 2006 and 2005, we recorded income tax expense for financial reporting purposes and accordingly reflected changes in our deferred tax assets. During the fourth quarter of 2006, we reversed the valuation allowance on deferred tax assets primarily representing net operating losses from our international operations, resulting in a reduction of $1.9 million to our income tax provision. As required by SFAS 109, we did not reverse the valuation allowance until it was more likely than not that the tax asset would be realized. 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. While this tax expense reduced net income, no cash will be paid for income taxes, other than required alternative minimum tax and foreign and state tax payments, until the NOL and tax credits have been fully utilized. Foreign NOLs will be utilized in jurisdictions where they are available and cash will be paid in jurisdictions that do not have foreign NOLs.

In 2004, we reversed the valuation allowance on U.S. deferred tax assets resulting in a net income tax benefit of $19.3 million. The deferred tax assets primarily represent the income tax benefit of U.S. NOLs and tax credits we have incurred. As required by SFAS 109, we did not reverse the valuation allowance until it was more likely than not that the tax assets would be realized.

We reevaluate our ability to realize our NOL and tax credit carryforwards in future periods and, in compliance with SFAS 109, record any resulting adjustments that may be required to deferred income tax expense. In addition, we reduce the deferred income tax asset for the benefits of NOL carryforwards actually used in future quarters as well as the reversing affect 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.

Liquidity and Capital Resources

Our cash and cash equivalents balance was $45.7 million as of December 31, 2006, compared to $26.8 million as of December 31, 2005. Cash and cash equivalents are primarily invested in money market accounts. Our short-term and long-term investment securities totaled $41.4 million as of December 31, 2006, compared to $44.0 million as of December 31, 2005. 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 $10.8 million in 2006, compared to cash used of $1.1 million in 2005 and cash provided of $2.6 million in 2004. The cash provided in 2006 compared to the cash used in 2005 was primarily due to increased net income, before non-cash stock-based compensation in our consolidated statements of operations and increases in accounts payable and accrued expenses, reduced by increases in accounts receivable and inventories. The cash used in 2005 compared to 2004 was primarily due to an increase in receivables resulting from increased sales and a decrease in accounts payable that were partially offset by an increase in accrued expenses and our non-cash deferred tax benefit.

We anticipate that cash provided by operations will increase slightly in 2007 compared to 2006 primarily due to anticipated continued profitable operations. 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.

Investing activities used cash of $3.1 million in 2006, compared to $0.7 million in 2005 and $7.2 million in 2004. The increase in cash used in 2006 compared to 2005 was due to an increase in purchases of property and equipment. The decrease in cash used in 2005 compared to 2004 was primarily due to $2.2 million of net sales/ maturities of investments in 2005 compared to $0.5 million of net purchases of investment securities in 2004. Additionally, cash used in investing activities decreased as a result of a reduction in purchases of property and equipment and a reduction in acquisition activities. We anticipate using cash to invest in high quality investment instruments in 2007, the extent of which will depend on the interest rate environment during the period and the timing of cash flows from our operations during the period.

Financing activities provided cash of $12.2 million in 2006 compared to $9.9 million in 2005 and $9.3 million in 2004. Cash provided by financing activities was primarily due to the exercise of stock options and our employee stock purchase plan totaling $10.2 million in 2006 compared to $9.9 million in 2005 and $9.4 million in 2004. Additional cash of $2.0 million was provided by the excess tax benefit from the exercise of stock options in 2006, which are required to be classified as cash provided by financing activities since our adoption of SFAS 123R in the first quarter of 2006.

We believe that our existing cash and cash generated from operations will be sufficient to fund our operations and planned capital expenditures in 2007. 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.

Off-balance sheet arrangements

During the year ended and as of December 31, 2006, we had no off-balance sheet arrangements, other than obligations under our operating leases reflected in the contractual obligations table below. Furthermore, 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, we are not a party to any derivative transaction.

We apply the disclosure provisions of FASB Interpretation No. 45, Guarantors 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 consolidated financial statements related to these indemnifications or guarantees.

Contractual obligations

We have the following contractual obligations as of December 31, 2006:

		Payments due by period			
	Total	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
			(in thousands)		
Operating leases	$16,487	$2,738	$4,698	$4,229	$4,822

Other commitments

In 2005, we entered into an agreement to contribute up to $1.0 million to a research university. This pledge, which is to be paid over a four-year period, is conditioned upon our election to make a payment on an annual basis. We contributed $0.3 million in 2006 and $0.1 million in 2005.

As part of our agreements with our suppliers, suppliers may procure resources and material expected to be used for the manufacture of our product 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.

As part of obtaining our lease for our current facility, we are required to deposit $0.1 million, representing restricted cash with our bank. Also, we were required to maintain a deposit of $0.6 million with our bank in the United Kingdom as security for payment of customs and duties charges. Both amounts are included in other long-term assets and are not included in the table above.

In the U.S., we have complemented our direct sales efforts by entering into group purchasing agreements with major healthcare group purchasing organizations (GPO). Typically, a GPO negotiates with medical suppliers, such as us, on behalf of the GPOs 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 GPOs 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. Currently, we have GPO supply agreements with various groups including AmeriNet, Inc., Premier, Inc., Novation LLC, MedAssets HSCA, Inc., Broadlane, Inc. (includes Kaiser Permanente, Tenet Healthcare and others) and Consorta, Inc. 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 $1.4 million in 2006, $1.0 million in 2005 and $0.5 million in 2004.

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 do not believe that the adoption of FIN 48 will have a significant impact 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 guidance in SAB 108. The adoption of SAB 108 did not impact our consolidated 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 for the Company.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159), including an amendment to FASB Statement No. 115. Under SFAS 159, entities may elect to measure specified financial instruments and warranty and insurance contracts at fair value on a contract-by-contract basis, with changes in fair value recognized in earnings each reporting period. The election, called the fair value option, will enable entities to achieve an offset accounting effect for changes in fair value of certain related assets and liabilities without having to apply complex hedge accounting provisions. SFAS 159 is expected to expand the use of fair value measurement consistent with the Boards long-term objectives for financial instruments. SFAS 159 is effective as of the beginning of a companys first fiscal year that begins after November 15, 2007. The Company is still in the process of evaluating the impact that adoption of SFAS 159 will have on its future consolidated financial statements.

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, 2006, our investments consisted of $38.4 million of interest-bearing debt securities with maturities of less than one year and $3.0 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 2007 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 foreign subsidiaries, we transact all our sales in USDs; therefore, the obligations of many of our international customers are in USDs. Our exposure to risk from fluctuations in foreign currencies relates primarily to the strengthening of the USD against the local currency of our international subsidiaries, which may result in foreign exchange losses on transactions with them, and our international customers, which may impact our ability to collect amounts owed by them.

As of December 31, 2006 56% of our outstanding accounts receivable balance was from international customers, of which 55%, or $16.2 million, was denominated in a currency other than USDs. Total sales for the year ended December 31, 2006 denominated in a currency other than USDs were $49.0 million, or 29% 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 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.

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 December 31, 2006, we had $7.5 million and $24.9 million in notional amount of foreign currency forward contracts that expire on January 29, 2007 and March 30, 2007, respectively. They serve as hedges of a substantial portion of our intercompany balances denominated in a currency other than the USD. These foreign currencies primarily include the British pound, the 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 $3.2 million. Conversely, if the USD strengthened by 10% against the applicable foreign currency, the fair value of these contracts would increase by $3.2 million. Any gains and losses in the fair value of these contracts would be largely mitigated by offsetting losses and gains on the underlying transactions. These offsetting gains and losses are not reflected in the sensitivity analysis above. The fair value of these contracts as of December 31, 2006 was not material to our results of operations or our financial position.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

SONOSITE, INC.
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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 (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of operations, cash flows and shareholders equity and comprehensive income for each of the years in the three-year period ended December 31, 2006. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule listed in Item 15(a). These consolidated financial statements and the financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and the 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, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, 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 2 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, effective January 1, 2006.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2006, 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 14, 2007 expressed an unqualified opinion on management s assessment of, and an adverse opinion on the effective operation of, internal control over financial reporting.

Seattle, Washington
March 14, 2007

/S/ KPMG LLP

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
SonoSite, Inc.:

We have audited management's assessment, included in the accompanying management's report on internal control over financial reporting (Item 9A(b)), that SonoSite, Inc. (the Company) did not maintain effective internal control over financial reporting as of December 31, 2006, because of the effect of the material weakness in the controls over income tax reporting, 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. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of 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, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and 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.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment:

As of December 31, 2006, the Company did not have the appropriate level of expertise to properly prepare and review its accounting for income taxes. As a result of this deficiency in the Company's internal control over financial reporting, management did not detect errors in the measurement of income tax amounts as of and for the year ended December 31, 2006. In addition, this deficiency resulted in more than a remote likelihood that a material misstatement of income taxes in the annual or interim consolidated financial statements would not be prevented or detected.

We have also audited in accordance with the standards of the Public Company Accounting Oversight Board (United States) the consolidated balance sheets of the Company as of December 31, 2006 and 2005, and the related consolidated statements of operations, cash flows and shareholder's equity and comprehensive income for each of the years in the three-year period ended December 31, 2006. This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2006 consolidated financial statements, and this report does not affect our report dated March 15, 2007, which expressed an unqualified opinion on those consolidated financial statements.

In our opinion, management's assessment that the Company did not maintain effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, because of the effect of the material weakness described above on the

achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Seattle, Washington
March 14, 2007

/s/ KPMG LLP

SONOSITE, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	As of December 31, 2006	2005
ASSETS		
Current Assets		
Cash and cash equivalents	$ 45,673	$ 26,809
Short-term investment securities	38,428	25,426
Accounts receivable, less allowances of $1,145 and $1,227	53,405	42,414
Inventories	23,020	20,735
Deferred income taxes	10,268	6,822
Prepaid expenses and other current assets	2,776	2,345
Total current assets	173,570	124,551
Property and equipment, net	10,185	7,388
Investment securities	3,014	18,569
Deferred income taxes	19,190	19,137
Goodwill	2,459	1,751
Identifiable intangible assets, net	1,405	1,822
Other assets	1,687	1,330
Total assets	$ 211,510	$ 174,548
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	$ 6,450	$ 4,148
Accrued expenses	15,459	12,467
Deferred revenue, current portion	3,253	2,937
Total current liabilities	25,162	19,552
Deferred rent and other	1,432	290
Warranty liability, net of current portion	1,541	507
Deferred revenue, net of current portion	2,344	2,157
Total liabilities	30,479	22,506
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, 2006—16,441,177		
As of December 31, 2005—15,872,078	164	159
Additional paid-in capital	231,387	212,709
Deferred stock compensation	—	(2,671)

Accumulated deficit	(51,777)	(59,008)
Accumulated other comprehensive income	1,257	853
Total shareholders equity	181,031	152,042
Total liabilities and shareholders equity	$ 211,510	$ 174,548

See accompanying notes to the consolidated financial statements.

SONOSITE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)

	For the Years Ended December 31,		
	2006	**2005**	**2004**
Revenue	$ 171,083	$ 147,491	$ 115,817
Cost of revenue	49,673	43,652	37,755
Gross margin	121,410	103,839	78,062
Operating expenses:			
Research and development	20,183	15,195	12,644
Sales and marketing	81,631	68,090	51,824
General and administrative	15,760	13,662	10,296
Total operating expenses	117,574	96,947	74,764
Other income (loss):			
Interest income	3,683	1,753	963
Interest expense		(2)	
Other	294	(795)	(601)
Total other income	3,977	956	362
Income before income taxes	7,813	7,848	3,660
Income tax (provision) benefit	(582)	(2,412)	19,312
Net income	$ 7,231	$ 5,436	$ 22,972
Net income per share:			
Basic	$ 0.44	$ 0.35	$ 1.55
Diluted	$ 0.43	$ 0.34	$ 1.46
Weighted average common and potential common shares outstanding:			
Basic	16,274	15,549	14,829
Diluted	16,857	16,175	15,737

See accompanying notes to the consolidated financial statements.

SONOSITE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	For the Years Ended December 31,		
	2006	**2005**	**2004**
Operating activities:			
Net income	$ 7,231	$ 5,436	$ 22,972
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	3,118	3,138	2,860
Loss on sale of property and equipment	49		
Net loss (gains) on investments	(5)	24	(36)

Equity in losses of affiliates		49	6
Amortization of net premiums (discounts) on investment securities	(386)	434	743
Stock-based compensation	7,328	297	139
Deferred income tax provision (benefit)	220	2,212	(19,546)
Excess tax benefit from exercise of stock options	(2,006)		
Changes in operating assets and liabilities:			
Accounts receivable	(9,400)	(10,301)	(6,959)
Inventories	(1,866)	(3,242)	(3,559)
Prepaid expenses and other assets	(593)	439	(1,929)
Accounts payable	2,289	(2,158)	3,276
Accrued expenses	3,237	1,859	4,087
Deferred liabilities	1,574	702	595
Net cash provided by (used in) operating activities	10,790	(1,111)	2,649
Investing activities:			
Purchase of investment securities	(93,963)	(46,787)	(31,722)
Proceeds from sales/maturities of investment securities	97,091	49,033	31,184
Purchase of property and equipment	(5,521)	(2,555)	(4,614)
Proceeds from sale of property and equipment	75		
Purchase of SonoSite China Medical Ltd		(402)	
Purchase of and earn-out consideration for SonoMetric Health, Inc.	(797)	(36)	(2,070)
Net cash used in investing activities	(3,115)	(747)	(7,222)
Financing activities:			
Excess tax benefit from exercise of stock options	2,006		
Proceeds from exercise of stock options and employee stock purchase plan	10,161	9,862	9,435
Repayment of long-term obligations			(88)
Net cash provided by financing activities	12,167	9,862	9,347
Effect of exchange rate changes on cash and cash equivalents	(978)	1,533	(1,185)
Net change in cash and cash equivalents	18,864	9,537	3,589
Cash and cash equivalents at beginning of year	26,809	17,272	13,683
Cash and cash equivalents at end of year	$ 45,673	$ 26,809	$ 17,272
Supplemental disclosure of cash flow information:			
Cash paid for income taxes	$ 102	$ 295	$ 28

See accompanying notes to the consolidated financial statements.

SONOSITE, INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY
AND COMPREHENSIVE INCOME
(in thousands, except shares)

	Common Stock Shares	Common Stock Amount	Additional paid-in capital	Deferred stock compensation	Accumulated deficit	Accumulated other comprehensive income	To share eq
Balance at December 31, 2003	14,572,524	$ 146	$ 180,839	$	$ (87,416)	$ 1,761	$ 9
Comprehensive income:							
Net income					22,972		2
Net unrealized loss on investment securities						(320)	
Less reclassification adjustment for gains included in net income						(36)	
Foreign currency translation adjustment						(196)	
Comprehensive income							2
Exercise of stock options	678,259	6	9,429				
Tax benefit from exercise of stock options			5,911				

Stock-based non-employee compensation			139				
Balance at December 31, 2004	15,250,783	152	196,318		(64,444)	1,209	133
Comprehensive income:							
Net income					5,436		
Net unrealized loss on investment securities, net of tax benefit of $39						(93)	
Less reclassification adjustment for losses included in net income						24	
Foreign currency translation adjustment						(287)	
Comprehensive income							
Exercise of stock options and employee stock purchase plan	621,295	7	9,855				
Restricted stock units granted			3,070	(3,070)			
Restricted stock units expensed				399			
Tax benefit from exercise of stock options			3,568				
Forfeiture of stock-based non-employee compensation			(102)				
Balance at December 31, 2005	15,872,078	159	212,709	(2,671)	(59,008)	853	151
Comprehensive income:							
Net income					7,231		
Net unrealized gain on investment securities, net of tax of $75						115	
Less reclassification adjustment for gains included in net income						(5)	
Foreign currency translation adjustment						294	
Comprehensive income							
Effect of adoption of SFAS 123R			(2,671)	2,671			
Exercise of stock options and employee stock purchase plan	569,099	5	10,156				10
Tax benefit from exercise of stock options			3,828				
Stock-based compensation			7,365				
Balance at December 31, 2006	16,441,177	$ 164	$231,387	$	$(51,777)	$1,257	$18

See accompanying notes to the consolidated financial statements.

SONOSITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Business Overview

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

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

2. Summary of Significant Accounting Policies

Basis of presentation and use of estimates

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

Reclassification of prior period balances

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

Cash and cash equivalents

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

Investment securities

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

A decline in market value of any available-for-sale security below cost that is determined to be other than temporary results in a revaluation of its carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the effective interest method. Interest income is recognized when earned. We may incur unrealized losses due to changes in market value attributable to changes in interest rates. We have the ability and intent to hold our investments until a recovery of cost, which may be maturity. Accordingly, we view any unrealized losses as temporary at December 31, 2006.

Accounts receivable

In the ordinary course of business, we grant credit to a broad customer base. Of the accounts receivable balance at December 31, 2006, 56% and 44% were receivable from international and domestic customers, prior to any allowance for doubtful accounts. The same percentages as of December 31, 2005 were 49% and 51% prior to any allowance for doubtful accounts.

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

Fair value of financial instruments

The carrying value of our financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and certain long-term other assets, approximates fair value. Cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to their short-term nature. Other long-term

assets approximate fair value as interest rates on these items approximate market. Our investment securities, which consist of high-grade debt securities, are carried at fair value.

We utilize foreign currency forward contracts to reduce our exposure to foreign currency risk due to fluctuations in exchange rates underlying the value of intercompany accounts receivable denominated in foreign currencies. We recognize all derivative financial instruments (foreign currency forward contracts) in accordance with Statement of Financial Accounting Standards (SFAS) No. 133 Accounting for Derivative Instruments and Hedging Activities, as amended. Changes in the fair value of derivative instruments are recorded in earnings unless hedge accounting criteria are met. For derivative instruments designated as fair value hedges, the changes in fair value of both the derivative instrument and the hedged item are recorded in earnings. For derivative instruments designed as cash flow and net investment hedges, the effective portions of changes in the fair value of the derivative are recorded in other comprehensive income. The ineffective portions are recognized in earnings. As of December 31, 2006, we had $7.5 million and $24.9 million in notional amount of foreign currency forward contracts that expire on January 29, 2007 and March 31, 2007, respectively. These contracts did not qualify as hedges under SFAS No.133 and therefore are marked-to-market with changes in fair value recorded in income from continuing operations.

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.

Property and equipment

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

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

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

Direct internal and external costs for computer software developed for internal use are capitalized in accordance with American Institute of Certified Public Accountants Statement of Position (SOP) No. 98-1, Accounting for Costs of Computer Software Developed or Obtained for Internal Use. Capitalized costs are amortized using the straight-line method over the estimated useful lives beginning when each module is complete and ready for use. Such costs totaled $0.2 million in 2006, $0.1 million in 2005 and $0.9 million in 2004.

The carrying value of long-lived assets is evaluated for impairment when events or changes in circumstances occur that may indicate the carrying amount of the asset may not be recoverable. For depreciable property and equipment and amortizable intangible assets, we evaluate the carrying value of the asset group by comparing the estimated future undiscounted cash flows generated from the use of the asset group and its eventual disposition

with the asset group's net book value. If the estimated future undiscounted cash flows from an asset group are less than the net book value of the asset group, we record an impairment loss equal to the excess of the net book value over the estimated fair market value of the asset group.

Goodwill and other intangible assets

In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, we perform goodwill impairment tests annually in the fourth quarter of each year, and more frequently if facts and circumstances indicate reporting unit carrying values exceed estimated reporting unit fair values. Intangibles subject to amortization, which consist mainly of acquired software technology and non-compete agreements, are amortized using the straight-line method over their estimated useful lives of three to seven years. Indefinite-lived intangible assets are tested for impairment annually, and more frequently if facts and circumstances indicate that the asset might be impaired.

Investment in and receivable from affiliates

When we have investments in companies where we have the ability to exercise influence, but not control, over operating and financial policies, these investments are accounted for under the equity method. Accordingly, our share in the net income or loss in these investees is included in other income or loss. We did not hold any such investments as of December 31, 2006 or December 31, 2005.

In 2003 and 2004, we invested a total of $0.2 million into SonoSite China Medical Limited (SonoSite China Medical) for a 30% ownership interest. In April 2005, we acquired the remaining 70% of SonoSite China Medical for $0.4 million. The results of SonoSite China Medical operations have been included in our consolidated financial statements since that date.

Concentration of credit and supply risk

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

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

Our circuit boards are produced by one of the world's largest electronic manufacturing services suppliers who produces the boards in their Thailand manufacturing facility. If we experience delays in the receipt or a deterioration in product yields of these components, we may experience delays in manufacturing or an increase in costs resulting in lost sales or a deterioration in gross margin.

Revenue recognition

We recognize revenue on products and accessories when goods are shipped under an agreement with a customer, risk of loss and title have passed to the customer and collection of any resulting receivable is reasonably assured. In cases of nonstandard delivery and acceptance criteria, we will not recognize revenue at shipment, but rather when the delivery and acceptance criteria have been satisfied. Revenue is recorded net of estimated returns. Sales discounts are recorded as a reduction of revenue. For service contracts, revenue is recognized as services are performed or over the term of the contract. Deferred revenue primarily represents unearned revenue from service contracts made under agreements with customers.

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

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

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. Our typical warranty period is one year except for the MicroMaxx system, which has, with certain exceptions, a five-year warranty period. The warranty is included with the original purchase. In addition to our standard warranty, we offer extended warranty and service agreements for coverage beyond the standard warranty period or coverage above what is covered by the standard warranty.

Research and development

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

Advertising costs

We expense costs for advertising and promotional activities as incurred. Advertising and promotional expenses for the years ended December 31, 2006, 2005 and 2004 were $11.7 million, $11.2 million, and $5.9 million.

Income taxes

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

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.

Stock-based compensation

Prior to adoption of SFAS No. 123R, "Share-Based Payment" ("SFAS 123R"), we accounted for those plans under the intrinsic value method in accordance with the provisions of Accounting Principles Bulletin ("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 Financial Accounting Standards Board 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 cash provided by financing activities, rather than as an operating cash flow on a prospective basis, and therefore reduces cash provided by operating activities and increases cash provided by financing activities. This amount, determined using the method provided by SFAS 123R for awards that were vested as of January 1, 2006, is shown as "Excess tax benefit from exercise of stock options" on our consolidated statement of cash flows. We have adopted the "long-haul" method to calculate the historical pool of windfall tax benefits, under which we calculate on a grant by grant basis the windfall or excess tax benefit that arose upon exercise of each award based on a comparison to the total tax deduction to the "as-if" deferred tax asset that would have been recorded had we followed the recognition provisions of SFAS 123 since its effective date. 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 has been previously reported.

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.

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

	Year Ended December 31,		
	2006	**2005**	**2004**
Net income	$ 7,231	$ 5,436	$ 22,972
Weighted average common shares outstanding used in computing basic net income per share	16,274	15,549	14,829
Effect of dilutive stock options and restricted stock units	583	626	908
Weighted average common and potential common shares outstanding used in computing diluted net income per share	16,857	16,175	15,737
Net income per share:			
Basic	$ 0.44	$ 0.35	$ 1.55
Diluted	$ 0.43	$ 0.34	$ 1.46

We exclude equity instruments from the calculation of diluted weighted average shares outstanding if the effect of including such instruments is antidilutive to net income per share. Accordingly, certain employee stock options and restricted stock units totaling approximately 344,000, 149,000 and 70,000 for years ended December 31, 2006, 2005 and 2004 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.

The following are the components of accumulated other comprehensive income at December 31 (in thousands):

	2006	2005	2004
Net unrealized loss on investments, net of tax	$ (214)	$ (324)	$ (255)
Cumulative translation adjustments	1,471	1,177	1,464
Total accumulated other comprehensive income	$1,257	$ 853	$1,209

Foreign currency translation

The functional currencies of our international subsidiaries, consisting primarily of the British pound, the Euro and the Japanese yen, are the local currency of the country in which the subsidiary is located. Assets and liabilities denominated in foreign currencies are translated at the exchange rate on the balance sheet date. Revenues, costs and expenses of international operations are translated at average rates of exchange prevailing during the period. Net realized and unrealized losses on currency transactions included in other income (loss) in the consolidated statements of operations were $0.4 million, $0.8 million and $0.6 million for the years ended December 31, 2006, 2005 and 2004.

Recent accounting pronouncements

In July 2006, the FASB issued 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 do not believe that the adoption of FIN 48 will have a significant impact 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 deemed material, but are material under the guidance in SAB 108. The adoption of SAB 108 did not impact our consolidated 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.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"), including an amendment to FASB Statement No. 115. Under SFAS 159, entities may elect to measure specified financial instruments and warranty and insurance contracts at fair value on a contract-by-contract basis, with changes in fair value recognized in earnings each reporting period. The election, called the fair value option, will enable entities to achieve an offset accounting effect for changes in fair value of certain related assets and liabilities without having to apply complex hedge accounting provisions. SFAS 159 is effective for fiscal years that begin after November 15, 2007. We are currently reviewing the provisions of SFAS 159 to determine the impact on our consolidated financial statements.

3. Technology Transfer and License Agreement with ATL

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.

Our license from ATL bears a royalty equivalent to a percentage of the net sales of ultrasound products under fifteen pounds that use ATL technology. A reduction in the royalty percentage owed to ATL became effective in September 2004. Royalty payments are required through September 21, 2007. For the years ended December 31, 2006, 2005 and 2004, we incurred a royalty expense to ATL of $2.2 million, $2.0 million and $2.6 million, which is included in cost of revenue.

4. Cash, cash equivalents and investment securities

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

	As of December 31,	
	2006	**2005**
Cash	$ 36,038	$ 7,002
Cash equivalents:		
Money market accounts	9,635	19,807
Total cash and cash equivalents	$ 45,673	$ 26,809
Investment securities:		
Short-term	$ 38,428	$ 25,426
Long-term	$ 3,014	$ 18,569

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

	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
2006:				
Short-term:				
U.S. Government and agencies	$ 4,047	$ —	$ (6)	$ 4,041
Corporate bonds	17,418	5	(22)	17,401
Asset-backed securities	17,108	—	(122)	16,986
Total short-term investments	$ 38,573	$ 5	$ (150)	$ 38,428
Long-term:				
Corporate bonds	$ 1,552	$ —	$ (14)	$ 1,538
Asset-backed securities	1,494	—	(18)	1,476
Total long-term investments	$ 3,046	$ —	$ (32)	$ 3,014
2005:				
Short-term:				
U.S. Government and agencies	$ 3,498	$ —	$ (14)	$ 3,484
Corporate bonds	9,748	—	(72)	9,676
Asset-backed securities	12,322	3	(59)	12,266
Total short-term investments	$ 25,568	$ 3	$ (145)	$ 25,426
Long-term:				
Corporate bonds	$ 8,212	$ —	$ (66)	$ 8,146
Asset-backed securities	10,577	2	(156)	10,423
Total long-term investments	$ 18,789	$ 2	$ (222)	$ 18,569

Long-term investments generally mature in less than three years.

SONOSITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table summarizes our realized gains and losses on investments for the years ended December 31 (in thousands):

	2006	2005	2004
Gains	$ 18	$ 1	$ 55
Losses	(13)	(25)	(19)
Realized gain (loss), net	$ 5	$ (24)	$ 36

Short-term and long-term investments with unrealized losses as of December 31, 2006, consisted of the following (in thousands):

Loss position for less than 12 months:	Gross Unrealized Holding Losses	Fair Value
U.S. Government and agencies	$ 6	$ 4,041
Corporate bonds	10	7,942

Asset-backed securities	22	7,414
	38	19,397
Loss position for more than 12 months:		
U.S. Government and agencies		
Corporate bonds	26	8,019
Asset-backed securities	118	9,710
	144	17,729
Total	$ 182	$37,126

The gross unrealized losses of $0.2 million on 36 securities as of December 31, 2006 and $0.4 million on 35 securities as of December 31, 2005, were primarily caused by changes in interest rates. There were no losses recognized for other-than-temporary impairments during 2006, 2005 or 2004.

5. Financial statement detail as of December 31, 2006 and 2005

Inventories consisted of the following (in thousands):

	2006	2005
Raw material	$ 9,035	$ 8,856
Work-in-process	19	58
Demonstration inventory	5,665	4,532
Finished goods	8,301	7,289
Total inventories	$ 23,020	$ 20,735

Property and equipment consisted of the following (in thousands):

	2006	2005
Equipment, other than computer	$ 12,623	$ 10,977
Software	6,725	5,128
Computer equipment	4,346	3,976
Furniture and fixtures	2,879	2,062
Leasehold improvements	2,564	1,554
	29,137	23,697
Less accumulated depreciation and amortization	(18,952)	(16,309)
Total property and equipment, net	$ 10,185	$ 7,388

Depreciation expense for the years ended December 31, 2006, 2005, and 2004 was $2.7 million, $2.7 million and $2.6 million.

Accrued expenses consisted of the following (in thousands):

	2006	2005
Payroll and related	$ 6,463	$ 7,601

Outside services	899	1,007
Warranty, current portion	777	488
Royalties	1,394	1,288
Other	5,926	2,083
Total accrued expenses	$15,459	$12,467

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

	Beginning of year	Charged to cost of revenue	Applied to liability	End of year
Year ended December 31, 2006	$ 995	$ 2,397	$ (1,074)	$2,318
Year ended December 31, 2005	$ 561	$ 1,049	$ (615)	$ 995
Year ended December 31, 2004	$ 381	$ 709	$ (529)	$ 561

6. Acquisitions

In May 2004, we acquired 100% of the outstanding common shares of SonoMetric Health, Inc. (SonoMetric). The results of SonoMetrics operations have been included in our consolidated financial statements since that date. SonoMetrics primary product was designed to be used with ultrasound technology to measure the intima media thickness (IMT) of the carotid artery. Increased thickness of the IMT in the carotid artery is associated with an increased risk of developing atherosclerosis, which is a leading cause of heart disease. We sell a stand-alone version of the acquired software, SonoCalc, and incorporated the software into the MicroMaxx system. We believe this acquisition enhances the sales of our products in the cardiovascular disease diagnostic market.

We purchased all of SonoMetrics outstanding common shares for an immediate cash payment of $1.5 million, plus future cash payments of up to $4.5 million contingent upon the amount of revenue recognized from the sale of the software over the five-year period following the closing date of the acquisition. In addition to the immediate cash payment, we also incurred $0.4 million in acquisition-related expenses, bringing the initial aggregate purchase price to $1.9 million. We had accrued contingent payments of $0.7 million and $0.7 million as of December 31, 2006 and 2005, respectively, as a result of revenue recognized on the sale of the software. These contingent payments are recorded as additional goodwill. This business combination was not material to our operations.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition. As part of the consideration paid to SonoMetric, the company paid off the assumed liabilities upon closing.

	At May 20, 2004
	(in thousands)
Intangible assets	$ 1,770
Goodwill	300
Total assets acquired	2,070
Other assets and liabilities, net	(182)
Net assets acquired	$ 1,888

SONOSITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Of the $1.8 million of acquired intangible assets, $1.3 million was assigned to existing software technology that is amortized using the straight-line basis over the estimated useful life of seven years and $0.5 million was assigned to non-compete agreements with former shareholders of SonoMetric that is amortized using the straight-line basis over the term of the agreement of three years. Contingent payments that are made are recorded as additional goodwill.

In 2004, in connection with the reduction of our valuation allowance related to U.S. income taxes, we recorded additional goodwill of $0.7 million related to the SonoMetric acquisition.

At December 31, 2004, we held a 30% ownership interest in SonoSite China Medical. In April 2005, we acquired the remaining 70% of SonoSite China Medical for $0.4 million. The results of SonoSite China Medical operations have been included in our consolidated financial statements since that date. The estimated fair value of the assets acquired and liabilities assumed at the date of acquisition was $0.5 million primarily for indefinite-lived intangible assets, including $0.1 million of deferred tax assets. The indefinite-lived intangible asset represents reacquired distribution rights. We have determined that they have indefinite lives because there are no legal, regulatory or contractual provisions that may limit their useful lives. We accounted for this acquisition in accordance with EITF Issue No. 04-01, Accounting for Preexisting Relationships between Parties to a Business Combination which provides that if certain conditions are met the settlement of a preexisting relationship should be recorded separate from the business combination. We concluded that none of those conditions existed in this transaction and accordingly none of the amount was recorded as settlement of a preexisting relationship.

7. Goodwill and other intangible assets

As of December 31, 2006, goodwill was $2.5 million and intangible assets subject to amortization, which collectively had a remaining weighted average useful life of 4.0 years, were $0.9 million, net of accumulated amortization of $1.1 million. Amortization expense of $0.4 million, $0.4 million and $0.3 million related to intangible assets was recorded for the years ended December 31, 2006, 2005 and 2004. Amortization expense of intangible assets is estimated to be $0.3 million in 2007, and $0.2 million per year in 2008, 2009 and 2010. As of December 31, 2006, indefinite-lived intangible assets were $0.5 million. During the fourth quarter of 2006, we completed our annual impairment assessment of our goodwill and indefinite-lived intangible assets and determined that they were not impaired.

8. Hedging activities

We periodically enter into foreign currency forward contracts to reduce the impact of adverse fluctuations on cash flows and earnings associated with foreign currency exchange rate changes. These contracts are not designated as hedges under SFAS 133 and therefore, are marked-to-market with changes in fair value recorded to earnings. These contracts are entered into for periods consistent with the currency transaction exposures, generally three months. Any gains and losses on the fair value of these contracts would be largely offset by losses and gains on the underlying transactions. We do not enter into any derivative transactions for speculative purposes.

The currencies hedged during 2006 were the British pound, the Euro, the Japanese yen, the Australian dollar and the Canadian dollar. As of December 31, 2006, we had $32.5 million in notional amount of foreign currency forward contracts. The fair value of these contracts as of December 31, 2006 was not material to our results of operations or financial position. These contracts expire on January 29, 2007 or March 30, 2007 and serve as economic hedges of a substantial portion of our intercompany balances denominated in a currency other than the USD. Net recognized gains (losses) from foreign currency forward contracts for the years ended December 31, 2006, 2005 and 2004 totaled $(1.1) million, $2.3 million and $(2.0) million, and are included in other income (loss) in the consolidated statements of operations. These gains and losses were substantially offset by foreign exchange gains and losses on intercompany balances.

SONOSITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Shareholders equity

Stock compensation plans

At December 31, 2006, we had seven stock-based employee compensation plans: the 1998 Nonofficer Employee Stock Option Plan (1998 NOE Plan), the 1998 Stock Option Plan (1998 Plan), the Nonemployee Director Stock Option Plan (Director Plan), the 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.

Total stock-based compensation expense recognized in our consolidated statement of operations for the years ended December 31, 2006, 2005 and 2004 were $7.3 million, $0.3 million and $0.1, respectively, before income taxes. Stock-based compensation expense relates to stock options of $4.0 million, RSU awards of $2.7 million and the employee stock purchase plan of $0.6 million in 2006, RSU awards of $0.4 million net of the reversal of stock options of $0.1 million in 2005, and stock options of $0.1 million in 2004. The related deferred tax benefit was $2.3 million and $0.1 million for the years ended December 31, 2006 and 2005. The amount of stock-based compensation capitalized to inventory was not material as of December 31, 2006.

Under the 1998 NOE Plan, 1998 Plan, MIC Plan, 2005 Plan and option grants outside our stock option plans, as of December 31, 2006, 2,797,851 total 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. As of December 31, 2006, 539,356 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 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.

Under the Director Plan, as of December 31, 2004, 125,000 shares of common stock were authorized for issuance of stock options at prices equal to the fair market value of our common shares at the date of grant. At December 31, 2004, there were no longer 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 all U.S. based employees to purchase shares of our common stock. Participating employees may purchase common stock through payroll deductions at the end of each participation period at a purchase price equal to 85% of the lower of the fair market value of the common stock at the beginning or the end of the participation period. As of December 31, 2006 1,000,000 shares of common stock were authorized for issuance under the 2005 ESPP Plan. During the years ended December 31, 2006 and 2005, 76,907 and 28,251 shares of common stock were issued under this plan, respectively.

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 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 December 31, 2006, 6,322 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.

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

In 2003, we granted 10,000 options to a non-employee and, in accordance with the provisions of SFAS No. 123, Accounting for Stock-based Compensation (SFAS 123) and EITF Issue No. 96-18, Accounting for Equity

Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services, calculated the fair value of the options using the Black-Scholes valuation model based on the following assumptions for the year ended December 31, 2004: expected volatility of 60%, risk-free interest rate of 4.2%, term of 9.1 years, and zero dividend yield. For the year ended December 31, 2004, we recorded stock-based compensation expense related to these options of $139,000 in accordance with the accelerated methodology described in FIN 28. During the year ended December 31, 2005, we determined that the vesting requirements of the 10,000 options would not be met. Accordingly, we reversed $102,000 in previously recorded stock-based compensation expense.

SONOSITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table illustrates the impact of our adoption of SFAS 123R on selected line items from our consolidated financial statements for the year ended December 31, 2006 (in thousands, except per share data):

	December 31, 2006	
	As Reported	Under APB 25
Income before income taxes	$ 7,813	$ 12,432
Net income	$ 7,231	$ 10,402
Net income per share:		
Basic	$ 0.44	$ 0.64
Diluted	$ 0.43	$ 0.62
Cash flows from operating activities	$10,790	$ 12,796
Cash flows from financing activities	$12,167	$ 10,161

The following table illustrates the effect on net income and net income per share if we had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation (in thousands, except per share data):

	2005	2004
Net income, as reported	$ 5,436	$22,972
Add: stock-based compensation expense included in reported net income, net of tax	255	
Deduct: stock-based compensation expense determined under fair value method for all awards, net of tax	(2,527)	8,803
Pro forma net income	$ 3,164	$31,775
Basic net income per share:		
As reported	$ 0.35	$ 1.55
Pro forma	$ 0.20	$ 2.14
Diluted net income per share:		
As reported	$ 0.34	$ 1.46
Pro forma	$ 0.19	$ 2.04

In 2004, we recognized $4.4 million of stock-based compensation expense offset by a $13.2 million tax benefit, which resulted from the reversal of the valuation allowance on U.S. deferred taxes. In years prior to 2004, there was no reduction of the expense for the related tax benefit because we retained a full valuation allowance offsetting the deferred taxes. The reversal of that valuation allowance in 2004 resulted in a tax benefit for pro forma disclosure.

Our results for prior years have not been restated.

The fair value for stock option awards was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions for the years ended December 31, 2006, 2005 and 2004:

	Stock Options			ESPP
	2006	2005	2004	2006
Expected term (in years)	4.6	5.4	6.5	0.5
Expected stock price volatility	41%	54%	57%	29%
Risk-free interest rate	4.6%	3.9%	3.5%	5.0%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Weighted average fair value of options granted	$16.45	$15.59	$14.10	$7.92

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 method 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 method, 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.

Summary of stock option activity

The following table presents summary stock option activity for the year ended December 31, 2006 (shares presented in thousands):

	Shares	Weighted average exercise price	Weighted average remaining contractual life	Aggregate intrinsic value (in thousands)
Outstanding, beginning of year	1,830	$18.95		
Granted	437	$39.95		
Exercised	(492)	$16.78		
Forfeited	(149)	$31.14		
Expired	(14)	$20.49		
Outstanding, end of year	1,612	$24.17	5.28	$ 14,260
Exercisable, end of year	1,230	$20.35	4.91	$ 13,818

The aggregate intrinsic value in the table above is based on our closing stock price of $30.93 as of December 31, 2006, which would have been received by the optionees, excluding applicable income taxes, had all options been exercised on that date. As of December 31, 2006, total unrecognized stock-based compensation expense related to nonvested stock options was $4.0 million, which is expected to be recognized over a weighted average period of approximately 1.8 years. During the years ended December 31, 2006, 2005 and 2004, the total intrinsic value of stock options exercised was $11.1 million, $10.5 million and $8.7 million, respectively.

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

SONOSITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a summary of stock options outstanding as of December 31, 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
$ 6.94 $15.47	370	3.16	$12.10	368	$12.09
$15.71 $19.35	366	5.91	$17.37	356	$17.40
$19.46 $28.25	345	5.68	$24.29	310	$24.42
$28.31 $38.97	266	6.18	$33.78	122	$31.30
$40.58 $40.58	265	5.93	$40.58	74	$40.58
	1,612	5.28	$24.17	1,230	$20.35

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 December 31, 2006, total unrecognized stock-based compensation expense related to nonvested RSU awards was $8.8 million, which is expected to be recognized over a weighted average period of approximately 2.3 years. During the year ended December 31, 2006, we recorded stock-based compensation expense related to these RSU awards of $2.7 million, net of $0.1 million of cumulative catch up adjustment that reduced the expense for the effect of estimated forfeitures.

The following table presents summary RSU award activity for the year ended December 31, 2006 (shares presented in thousands):

	Shares	Weighted average grant date fair value
Non-vested, beginning of period	93	$ 33.05
Granted	387	$ 36.52
Vested		$
Forfeited	(66)	$ 36.99
Non-vested, end of period	414	$ 35.67

No RSU awards vested during the year ended December 31, 2006.

Stock purchase rights

In April 1998, we and First Chicago Trust Company of New York (First Chicago) entered into a Rights Agreement. The Rights Agreement was subsequently amended in October 2001 to reflect that EquiServe Trust Company, N.A. had succeeded First Chicago as the rights agent, and in August 2003, to reflect certain changes approved by our Board of Directors. The Rights Agreement has certain anti-takeover provisions, which will cause substantial dilution to a person or group that attempts to acquire us. Under the Rights Agreement, each of our shareholders has one share purchase right for each share of common stock held, with each right having an exercise price approximating our board of directors estimate of the long-term value of one share of our common stock. The rights are triggered if an acquiror acquires, or successfully makes a tender offer for, 20% or more of our outstanding common stock. In such event, each shareholder other than the acquiror would have the right to purchase, at the exercise price, a number of newly issued shares of our capital stock at a 50% discount. If the acquiror were to acquire 50% or more of our assets or earning power, each shareholder would have the right to purchase, at the exercise price, a number of shares of acquiror s stock at a 50% discount. Our board of directors may redeem the rights at a nominal cost at any time before a person acquires 20% or more of our outstanding common stock, which allows board-approved transactions to proceed. In addition, our board of directors may exchange all or part of the rights (other than rights held by the acquiror) for such number of shares of our common stock equal in value to the exercise price. Such an exchange produces the desired dilution without actually requiring our shareholders to purchase shares.

SONOSITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Income taxes

The components of income before income taxes are as follows (in thousands):

	2006	2005	2004
U.S. operations	$ 5,334	$ 6,550	$ 11,042
Foreign operations	2,479	1,298	(7,382)
Total income before income taxes	$ 7,813	$ 7,848	$ 3,660

The components of income tax (provision) benefit are as follows (in thousands):

	2006	2005	2004
Current:			
U.S. Federal	$ (170)	$ (96)	$ (134)
State and local	(77)	(27)	(100)
Foreign	(115)	(77)	
Total Current	(362)	(200)	(234)
Deferred:			
U.S. Federal	(1,931)	(2,088)	19,169
State and local	(141)	(124)	377
Foreign	1,852		
Total Deferred	(220)	(2,212)	19,546
Total income tax (provision) benefit	$ (582)	$ (2,412)	$ 19,312

The provision for income taxes differs from the amount computed by applying the federal statutory income tax rate to the net income or loss. The sources and tax effects of the differences for the years ended December 31 are as follows:

	2006	2005	2004

U.S. federal tax expense at statutory rates	34.0%	34.0%	34.0%
State income taxes, net of federal benefits	1.9%	1.9%	1.8%
Meals and entertainment	1.6%	1.3%	2.3%
Expiring state net operating losses	1.3%		
Research and experimentation credits	(2.5)%	(2.7)%	(2.0)%
Other	2.7%	(3.8)%	4.2%
Valuation allowance changes and tax uncertainties	(31.6)%	—	(568.0)%
Effective tax rate	7.4%	30.7%	(527.7)%

SONOSITE, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The tax effects of temporary differences and carryforwards that give rise to significant portions of deferred tax assets and deferred tax liabilities at December 31 are as follows (in thousands):

	2006	2005
Deferred tax assets:		
Domestic net operating loss carryforwards	$16,336	$19,971
Foreign net operating loss carryforwards and other deferred tax items	1,237	3,981
Research and experimentation tax credit carryforwards	2,498	2,574
Allowances and accruals not recognized for tax purposes	5,980	2,397
Stock-based compensation	2,346	144
Other	1,193	1,140
Gross deferred tax assets	29,590	30,207
Valuation allowance	—	(3,981)
	29,590	26,226
Deferred tax liabilities:		
Depreciation and amortization	(132)	(267)
Net deferred tax assets	$29,458	$25,959

The valuation allowance on deferred taxes decreased by $4.0 million in 2006, decreased by $1.0 million in 2005 and decreased by $23.7 million in 2004.

We have no valuation allowance on the U.S. deferred tax assets since it is more likely than not the deferred assets will be realized. The effect of the removal of the valuation allowance on the U.S. deferred tax assets in 2004, partially offset by an increase in the valuation allowance on foreign NOL carryovers, was a reduction in the deferred tax asset valuation allowance in 2004 of $23.7 million.

The valuation allowance on foreign deferred tax assets was eliminated in 2006 because current operations and recent earnings history indicate that realization of the related deferred tax assets are now more likely than not to occur.

For income tax purposes, our results through the spin-off from ATL were included in the consolidated federal income tax return of ATL and, accordingly, the net operating loss ("NOL") generated prior to the spin-off from ATL is not available to us for use in periods subsequent to that date. During the period from the spin-off from ATL through December 31, 2006 we accumulated U.S. federal income tax NOL carryforwards of $47.6 million that begin expiring in 2019 and will be fully expired in 2025 and foreign NOL carryforwards of $10.7 million, of which $10.3 million are perpetual in nature and $0.4 expire in 2014. Additionally, we accumulated research and experimentation tax credit carryforwards of $2.5 million that will expire between 2018 and 2026 and alternative minimum tax credits of $0.4 million that are perpetual in nature.

We have not provided for U.S. deferred taxes on earnings of non-U.S. subsidiaries as such earnings are deemed permanently reinvested. Determination of unrecorded deferred taxes on earnings of non-U.S. subsidiaries is not practicable.

Under certain provisions of the Internal Revenue Code of 1986, as amended, the availability and utilization of our NOL and tax credit carryforwards may be subject to limitation if it should be determined that there has been a change in ownership of more than 50%.

11. Employee Benefit Plan

401(k) Retirement Savings Plan

All our employees in the U.S. are eligible to participate in our 401(k) Plan. Terms of the 401(k) Plan permit an employee to contribute up to a maximum of 16% of an employee's annual compensation on a post-tax or pre-tax basis, up to the maximum permissible by the Internal Revenue Service during any plan year. We match each employee's contribution in increments equivalent to 100% for the first 3% and 50% for the second 3% of the employee's contribution percentage. In 2006, 2005 and 2004 we contributed $1.3 million, $1.0 million and $0.9 million in matching contributions to the 401(k) Plan in accordance with the plan's terms. Employees immediately vest in the contributions the employee makes. Vesting in our contribution on behalf of the employee occurs at equal increments at the end of each year of the first five years of an employee's service with us.

12. Commitments and contingencies

Indemnification Obligations and Guarantees (excluding product warranty)

We apply the disclosure provisions of FASB Interpretation No. 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.

Operating leases

We currently lease office and manufacturing space, automobiles and office equipment under operating leases. As of December 31, 2006, future minimum lease payments are as follows (in thousands):

2007	$ 2,738
2008	2,449
2009	2,249
2010	2,128
2011	2,101
Thereafter	4,822
Total	$16,487

Rent expense for the years ended December 31, 2006, 2005 and 2004 was $2.3 million, $2.7 million and $2.2 million.

Other commitments

In 2005, we entered into an agreement to contribute up to $1.0 million to a research university. This pledge, which is to be paid over a four-year period, is conditioned upon our election to make a payment on an annual basis. We paid $0.3 million in 2006 and $0.1 million in 2005.

As part of our agreements with our suppliers, suppliers may procure resources and material expected to be used for the manufacture of our product in accordance with our production schedule provided to them. 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, we may be responsible for compensating our suppliers for these procurements. As of December 31, 2006, these commitments were not significant.

As part of obtaining our lease for our current facility, we are required to deposit $0.1 million, representing restricted cash with our bank. Additionally, at December 31, 2006 we maintained a deposit of $0.6 million with our bank in the United Kingdom as security for payment of customs and duties charges. Both amounts are included in other long-term assets.

In the U.S., we have complemented our direct sales efforts by entering into group purchasing agreements with major healthcare group purchasing organizations (GPO). Typically, a GPO negotiates with medical suppliers, such as us, on behalf of the GPOs 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 GPOs 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. Currently, we have GPO supply agreements with various groups including AmeriNet, Inc., Premier, Inc., Novation LLC, MedAssets HSCA, Inc., Broadlane, Inc. (includes Kaiser Permanente, Tenet Healthcare and others) and Consorta, Inc. These agreements require us to pay fees based on the amount of sales generated from these agreements. For the years ended December 31, 2006, 2005 and 2004, we recorded fees related to these agreements as sales and marketing expenses in the amounts of $1.4 million, $1.0 million and $0.5 million, respectively.

Contingencies

In December 2006, a favorable judgment from a Federal U.S. District Court in Texas was affirmed at the appellate level in a patent infringement suit that had been pending against us 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, attorneys fees and costs, and pre- and post-judgment interest. On September 30, 2004, the Texas court ruled that SonoSites products infringed the 021 patent claims as previously construed by the court.

On March 21, 2006, the district court granted SonoSites 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 portable and sized to be 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 filed a notice of appeal to the U.S. Court of Appeals for the Federal Circuit in Washington, D.C. and oral argument on the appeal took place on December 5, 2006. On December 8, 2006, the Court of Appeals unanimously affirmed the Texas court s summary judgment of invalidity in favor of SonoSite, and relied on the District Court s opinion instead of writing a new one. On December 15, 2006, Neutrino filed a motion for a panel rehearing and a motion for a rehearing en banc. The Court of Appeals denied both motions on January 19, 2007. On January 24, 2007, Neutrino filed a notice with the Texas district court of its intent to file a Petition of Certiorari to the U.S. Supreme Court. We have not yet seen the petition. Our motions to declare the case exceptional and to recover our attorneys fees and costs are pending in the Texas district court. We expense legal costs as incurred.

13. Segment reporting

We currently have one reportable segment. We market our products in the United States and internationally through our direct sales force and our indirect distribution channels. Our chief operating decision maker evaluates resource allocation decisions and our performance based upon revenue recorded in geographic regions and does not receive financial information about expense allocation on a disaggregated basis. Geographic regions are determined by the shipping destination. Revenue by geographic location for the years ended December 31 is as follows (in thousands):

	2006	2005	2004
United States	$ 89,732	$ 79,794	$ 61,253
Europe, Africa and the Middle East	48,940	41,213	35,016
Japan	12,633	11,939	9,731
Canada, South and Latin America	12,260	9,580	4,678
Asia Pacific	7,518	4,965	5,139
Total revenue	$171,083	$147,491	$115,817

Long-lived assets, excluding investment securities, deferred tax assets and restricted cash, included in other assets, by geographic location as of December 31 are as follows (in thousands):

	2006	2005
United States	$13,233	$ 9,987
International	1,663	1,599
Total long-lived assets	$14,896	$11,586

14. Quarterly results unaudited

	For the three months ended, June 30

	March 31		September 30	December 31
	(in thousands, except per share amounts)			
2006:				
Revenue	$ 36,869	$ 39,515	$ 40,346	$ 54,353
Cost of revenue	10,991	10,835	11,707	16,140
Gross margin	25,878	28,680	28,639	38,213
Operating expenses	27,085	27,896	29,230	33,363
Other income (loss)	660	1,132	1,125	1,060
Income tax (provision) benefit	184	(622)	(59)	(85)
Net income (loss)	$ (363)	$ 1,294	$ 475	$ 5,825
Net income (loss) per share:				
Basic	$ (0.02)	$ 0.08	$ 0.03	$ 0.35
Diluted	$ (0.02)	$ 0.08	$ 0.03	$ 0.34
Shares used in computation of net income (loss) per share:				
Basic	16,013	16,303	16,366	16,409
Diluted	16,013	16,922	16,903	16,918
2005:				
Revenue	$ 33,965	$ 33,515	$ 34,809	$ 45,202
Cost of revenue	10,120	10,367	10,297	12,868
Gross margin	23,845	23,148	24,512	32,334
Operating expenses	22,232	26,276	22,442	25,997
Other income (loss)	(224)	122	454	604
Income tax (provision) benefit	(664)	954	(1,078)	(1,624)
Net income (loss)	$ 725	$ (2,052)	$ 1,446	$ 5,317
Net income (loss) per share:				
Basic	$ 0.05	$ (0.13)	$ 0.09	$ 0.34
Diluted	$ 0.05	$ (0.13)	$ 0.09	$ 0.32
Shares used in computation of net income (loss) per share:				
Basic	15,318	15,431	15,630	15,810
Diluted	15,961	15,431	16,285	16,397

The quarterly information presented above reflects, in the opinion of management, all adjustments necessary (which are of a normal and recurring nature, except for a tax benefit recorded in the quarter ended December 31, 2006 related to the reversal of the valuation allowance on foreign deferred taxes) for a fair presentation of the results for the interim period presented.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures

As of December 31, 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, due to the material weakness

in internal control over financial reporting described below, our disclosure controls and procedures were not 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.

(b) Management's report on internal control over financial reporting

Our management is responsible for establishing and maintaining adequate internal controls over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2006 as required by the Exchange Act Rule 13a-15(c). In making this assessment, our management used the criteria issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control Integrated Framework.*

A "material weakness" is defined as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Our management s evaluation and assessment of our internal control over financial reporting concluded that internal control over financial reporting was ineffective as of December 31, 2006, as a result of the following material weakness:

As of December 31, 2006, we did not have the appropriate level of expertise to properly prepare and review our accounting for income taxes. As a result of this deficiency in our internal control over financial reporting, we did not detect errors in the measurement of income tax amounts as of and for the year ended December 31, 2006. In addition, this deficiency resulted in more than a remote likelihood that a material misstatement of income taxes in the annual or interim consolidated financial statements would not be prevented or detected.

KPMG LLP, an independent registered public accounting firm, has issued an audit report on management's assessment of our internal control over financial reporting. Their report is included in Item 8. in the section titled "Reports of Independent Registered Public Accounting Firm."

(c) Changes in internal control over financial reporting

During 2006, we have made various improvements to our system of internal control. We continue to review, revise and improve the effectiveness of our internal controls. We have made no changes, other than the items noted below, in the Company's internal control over financial reporting in connection with our fourth quarter evaluation that would materially affect, or are reasonably likely to materially affect, our internal control over financial reporting.

During our fourth quarter of 2006, our tax resources, who had the background and expertise in the tax provision preparation process, resigned. We continued to use a third party tax firm to provide expertise related to accounting and reporting for income taxes and plan to hire additional tax resources in 2007.

ITEM 9B. OTHER INFORMATION

For each of the executive officers named in the 2007 proxy statement under the heading "Executive Officers," we have entered into change-in-control agreements. These agreements are substantially similar to each other. We will file the proxy statement within 120 days of December 31, 2006.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this Item is included in our proxy statement for our 2007 annual meeting of shareholders and is incorporated by reference. The information appears in the proxy statement under the headings "Election of Directors" and "Executive Officers." We will file the proxy statement within 120 days of December 31, 2006.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is included in our proxy statement for our 2007 annual meeting of shareholders and is incorporated by reference. The information appears in the proxy statement under the heading "Executive Compensation." We will file the proxy statement within 120 days of December 31, 2006.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Security Ownership of Certain Beneficial Owners and Management

The information required by this Item is included in our proxy statement for our 2007 annual meeting of shareholders and is incorporated by reference. The information appears in the proxy statement under the heading "Security Ownership of Certain Beneficial Owners and Management." We will file the proxy statement within 120 days of December 31, 2006.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table provides information regarding our existing compensation plans and individual compensation arrangements pursuant to which our equity securities may be issued to employees, directors, consultants, advisors or other persons in exchange for consideration in the form of services as of December 31, 2006.

Plan Category	Number of securities to be issued upon exercise of outstanding options, restricted stock units, warrants and rights (a)	Weighted-average exercise price of outstanding options, restricted stock units, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,565,000 (1)	$18.57	402,000
Equity compensation plans not approved by security holders	461,000 (2)	$21.48	137,000
Total	2,026,000	$19.23	539,000

(1) Issuable under our 1998 Stock Option Plan, Management Incentive Compensation Plan, Nonemployee Director Stock Option Adjustment Plan and 2005 Stock Incentive Plan. The plans are described in Note 9 to the Consolidated Financial Statements in our Annual Report on Form 10-k for the fiscal year ended December 31, 2006.

(2) Issuable under our 1998 Nonofficer Employee Stock Option Plan as described in Note 9 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006. Also includes 85,000 options outside of all plans issued to corporate officers, which are also described in Note 9 to the Consolidated Financial Statements.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item is included in our proxy statement for our 2007 annual meeting of shareholders and is incorporated by reference. The information appears in the proxy statement under the heading Certain Relationships and Related Transactions. We will file the proxy statement within 120 days of December 31, 2006.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is included in our proxy statement for our 2007 annual meeting of shareholders and is incorporated by reference. The information appears in the proxy statement under the heading Fee Disclosures. We will file the proxy statement within 120 days of December 31, 2006.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Documents filed as part of this report:

(1) Financial Statements See Index to Financial Statements under Item 8 of this Report.

(2) Financial Statement Schedule.

Schedule II
Valuation and Qualifying Accounts

	Balance at beginning of year	Additions charged to general and administrative expense or revenue	Deductions	Balance at end of year
		(in thousands)		
Year ended December 31, 2006:				
Accounts receivable allowances	$ 1,227	$ 1,500	$ 1,582	$ 1,145
Year ended December 31, 2005:				
Accounts receivable allowances	$ 942	$ 854	$ 569	$ 1,227
Year ended December 31, 2004:				
Accounts receivable allowances	$ 933	$ 501	$ 492	$ 942

(3) Exhibits.

Exhibit

No.	Description
3.1 (A)	Restated Articles of Incorporation of the registrant (exhibit 3.1)
3.3 (E)	Amended and Restated Bylaws of the registrant (exhibit 3.1)
4.1 (A)	Rights Agreement between First Chicago Trust Company and the registrant, dated April 6, 1998 (exhibit 4.1)
4.2 (E)	Amendment to Rights Agreement, dated August 8, 2001 (exhibit 4.2)
4.3 (F)	Amendment to Rights Agreement, dated October 24, 2001 (exhibit 4.3)
4.4 (I)	Amendment to Rights Agreement, dated August 25, 2003 (exhibit 4.1)
10.1 (G)	1998 Stock Option Plan, as amended and restated (exhibit 10.1)
10.2 (A)	Terms of Stock Option Grant Program for Nonemployee Directors under the SonoSite, Inc. 1998 Stock Option Plan (exhibit 10.2)
10.3 (H)	1998 Nonofficer Employee Stock Option Plan, as amended and restated (exhibit 10.1)
10.4 (E)	Nonemployee Director Stock Option Plan, as amended and restated (exhibit 10.3)
10.5 (C)	Management Incentive Compensation Plan (exhibit 10.5)
10.6 (B)	Adjustment Plan (exhibit 10.6)
10.7 (A)	Form of Senior Management Employment Agreement between the registrant and each of Kevin M. Goodwin, Michael J. Schuh and Bradley G. Garrett (exhibit 10.7)
10.8 (A)	Technology Transfer and License Agreement between ATL Ultrasound, Inc. and the registrant, effective as of April 6, 1998, as amended (exhibit 10.9)
10.9 (F)	Third Amendment to Technology Transfer and License Agreement between ATL Ultrasound, Inc. and the registrant, dated as of March 10, 2000 (exhibit 10.9)
10.10 (D)	Lease Agreement between Riggs & Company, a division of Riggs Bank N.A., and the registrant, dated December 28, 1999 (exhibit 10.14)
10.11 (D)*	Distribution Agreement between Olympus Optical Co. Ltd. and the registrant, dated August 1, 1999 (exhibit 10.15)
10.12 (F)	Assignment of Distribution Agreement by and among Olympus Optical Co., Ltd., Olympus Promarketing, Inc. and the registrant, dated effective September 28, 2001 (exhibit 10.12)
10.13 (J)	Option Notice Agreement, dated July 17, 2000, between the registrant and Michael J. Schuh (exhibit 99.1)
10.14 (J)	Option Notice Agreement, dated July 24, 2000, between the registrant and Daniel Walton (exhibit 99.2)
10.15 (K)	Option Notice Agreement, dated September 11, 2003, between the registrant and Henry (Skip) Krause (exhibit 99.1)
10.16 (K)	Option Notice Agreement, dated September 22, 2003, between the registrant and Marla Koreis (exhibit 99.2)
10.17 (L)*	Distribution Agreement between Boston Scientific Corporation and the registrant, dated August 4, 2004 (exhibit 10.1)
10.18 (M)	SonoSite, Inc. FY2005 Variable Incentive Bonus Plan (exhibit 10.1)
10.19 (N)	2005 Stock Incentive Plan (exhibit 10.1)
10.20 (N)	2005 Employee Stock Purchase Plan (exhibit 10.2)

10.21 (O)	Nonqualified Stock Option Notice Agreement between the registrant and Mike Ambielli (exhibit 99.1)
10.21 (O)	Nonqualified Stock Option Notice Agreement between the registrant and John Lowell (exhibit 99.2)
10.23 (P)	1998 Stock Option Plan Stock Option Award Agreement (exhibit 10.1)
10.24 (P)	2005 Stock Incentive Plan Restricted Stock Unit Agreement (exhibit 10.2)
10.25 (P)	2005 Stock Incentive Plan Stock Option agreement (Nonstatutory) (exhibit 10.3)
10.26 (Q)	Separation Agreement and General Release between the registrant and Henry Krause dated August 8, 2005 (exhibit 10.1)
10.27 (R)	FY2006 Variable Incentive Bonus Plan (exhibit 10.1)
10.28 (S)	Terms of Stock Option Grant Program for Nonemployee Directors under the SonoSite, Inc. 2005 Stock Incentive Plan (exhibit 10.1)
10.29 (S)	2005 Stock Incentive Plan Stock Option Agreement (Non Statutory) (exhibit 10.2)
10.30 (S)	2005 Stock Incentive Plan Restricted Stock Unit Agreement (Non Statutory) (exhibit 10.3)
10.31 (T)	FY2007 Variable Incentive Bonus Plan (exhibit 10.1)
21.1	Subsidiaries of the registrant
23.1	Consent of KPMG LLP, independent registered public accounting firm
24.1	Power of attorney (contained on signature page)
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	

	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350 (Section 906 of the Sarbanes-Oxley Act of 2002)
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350 (Section 906 of the Sarbanes-Oxley Act of 2002)

	Filed herewith.
*	Confidential treatment requested.
(A)	Incorporated by reference to the designated exhibit included in SonoSite's Registration Statement on Form S-1 (Registration No. 333-714157) filed on October 3, 1999.
(B)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 10 (SEC File No. 000-23791) filed on March 19, 1998.
(C)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 10-K for the year ended December 31, 1998 (SEC File No. 000-23791) filed on March 22, 1999.
(D)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 10-K for the year ended December 31, 1999 (SEC File No. 000-23791) filed on March 30, 2000.
(E)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 10-Q for the quarter ended September 30, 2001 (SEC File No. 000-23791) filed on November 13, 2001.
(F)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 10-K for the year ended December 31, 2001 (SEC File No. 000-23791) filed on February 22, 2002.
(G)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 10-Q for the quarter ended March 31, 2002 (SEC File No. 000-23791) filed on May 13, 2002.
(H)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 10-Q for the quarter ended June 30, 2002 (SEC File No. 000-23791) filed on August 13, 2002.
(I)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 8-K filed on August 26, 2003 (SEC File No. 000-23791) filed on August 26, 2003.
(J)	Incorporated by reference to the designated exhibit included in SonoSite's registration statement on Form S-8 (Registration No. 333-51820) filed on December 14, 2000.
(K)	Incorporated by reference to the designated exhibit included in SonoSite's registration statement on Form S-8 (Registration No. 333-110913) filed on December 4, 2003.
(L)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 10-Q for the quarter ended September 30, 2004 (SEC File No. 000-23791) filed on November 9, 2004.
(M)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 8-K (SEC File No. 000-23791) filed on December 20, 2004.
(N)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 8-K filed on April 28, 2005.
(O)	Incorporated by reference to the designated exhibit included in SonoSite's registration statement on Form S-8 filed on April 29, 2005.
(P)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 10-Q for the quarter ended June 30, 2005 filed on August 9, 2005.
(Q)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 8-K filed on September 15, 2005.
(R)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 8-K filed on December 9, 2005.
(S)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 8-K filed on February 7, 2006.
(T)	Incorporated by reference to the designated exhibit included in SonoSite's report on Form 8-K filed on February 15, 2007.

SIGNATURES

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.

By /s/ Michael J. Schuh

Michael J. Schuh
Vice President-Finance, Chief Financial Officer, and Treasurer

Date: March 14, 2007

POWER OF ATTORNEY

Each person whose individual signature appears below hereby authorizes and appoints Kevin M. Goodwin and Michael J. Schuh, and each of them, with full power of substitution and resubstitution and full power to act without the other, as his true and lawful attorney-in-fact and agent to act in his name, place and stead and to execute in the name and on behalf of each person, individually and in each capacity stated below, and to file, any and all amendments to this report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing, ratifying and confirming all that said attorneys-in-fact and agents or any of them or their or his substitute or substitutes may lawfully do or cause to be done by virtue thereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Company and in the capacities indicated below on the 14th day of March 2007.

/S/ KIRBY L. CRAMER **Kirby L. Cramer**	Chairman of the Board
/S/ KEVIN M. GOODWIN **Kevin M. Goodwin**	President, Chief Executive Officer and Director (Principal Executive Officer)
/S/ MICHAEL J. SCHUH **Michael J. Schuh**	Vice President-Finance, Chief Financial Officer, and Treasurer (Principal Financial and Accounting Officer)
/S/ CARMEN L. DIERSEN **Carmen L. Diersen**	Director
/S/ EDWARD V. FRITZKY **Edward V. Fritzky**	Director
/S/ STEVEN R. GOLDSTEIN, M.D. **Steven R. Goldstein, M.D.**	Director
/S/ PAUL V. HAACK **Paul V. Haack**	Director
/S/ ROBERT G. HAUSER, M.D. **Robert G. Hauser, M.D.**	Director
/S/ WILLIAM G. PARZYBOK, JR. **William G. Parzybok, Jr.**	Director
/S/ JEFFREY PFEFFER, PH.D. **Jeffrey Pfeffer, Ph.D.**	Director
/S/ JACQUES SOUQUET, PH.D. **Jacques Souquet, Ph.D.**	Director

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