

MEDSTONE INTERNATIONAL INC/
Form 10-Q
August 13, 2003

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2003

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 0-16752

MEDSTONE INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

66-0439440

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

100 Columbia, Suite 100, Aliso Viejo, California

92656

(Address of principal executive offices)

(Zip code)

Registrant's telephone number, including area code: (949) 448-7700

Not Applicable

(Former name, former address and former fiscal year, if changed, since last report)

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.

YesNo

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

YesNo

The number of shares of the Common Stock of the registrant outstanding as of August 6, 2003 was 3,758,220. The number of shares voting and non-voting Common Stock held by non-affiliates on such date was 3,664,512 with an approximate aggregate market value of \$11,176,762.

MEDSTONE INTERNATIONAL, INC.

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**MEDSTONE INTERNATIONAL, INC.
CONSOLIDATED BALANCE SHEETS**

	June 30, 2003	December 31, 2002
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 1,765,273	\$ 2,050,466
Short-term investments held to maturity	4,374,214	4,323,491
Accounts receivable, less allowance for doubtful accounts of \$977,822 and \$871,769 at June 30, 2003 and December 31, 2002, respectively	3,679,878	3,720,410
Income taxes receivable	589,375	589,375
Inventories, less allowance for inventory obsolescence of \$791,700 and \$642,712 at June 30, 2003 and December 31, 2002, respectively	5,993,065	6,440,304
Deferred tax assets	955,877	955,877
Prepaid expenses and other current assets	947,330	647,169
	<u>18,305,012</u>	<u>18,727,092</u>
Buildings, property and equipment, at cost:		
Building	359,324	359,324
Lithotripters	14,177,305	13,524,440
Equipment, furniture and fixtures	3,428,574	3,368,431
Leasehold improvements	177,318	177,318
	<u>18,142,521</u>	<u>17,429,513</u>
Less accumulated depreciation and amortization	(14,365,997)	(13,602,049)
	<u>3,776,524</u>	<u>3,827,464</u>
Net property and equipment		
	<u>3,776,524</u>	<u>3,827,464</u>
Goodwill, net	2,929,897	2,929,897
Investment in unconsolidated subsidiaries	950,358	734,083
Net investment in sale-type lease	311,949	169,428
Other assets, net	80,716	93,243
	<u>26,354,456</u>	<u>26,481,207</u>
	<u>\$ 26,354,456</u>	<u>\$ 26,481,207</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,028,627	\$ 900,295
Accrued expenses	247,610	267,229
Accrued payroll expenses	366,787	366,855
Customer deposits	133,420	75,175
Deferred revenue	399,527	494,704
	<u>2,175,971</u>	<u>2,104,258</u>
Total current liabilities		
	<u>2,175,971</u>	<u>2,104,258</u>
Deferred tax liabilities	639,224	639,224
Minority interest	398,860	423,224
Deferred rent	75,657	82,613
Commitments and contingencies (Note F)		
Stockholders' equity:		
Common stock - \$.004 par value, 20,000,000 shares authorized, 5,742,670 shares issued at both June 30, 2003 and December 31, 2002	22,971	22,971
Additional paid-in capital	19,646,388	19,646,388

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Accumulated earnings	16,166,447	16,350,292
Accumulated other comprehensive loss	(5,353)	(22,054)
Treasury stock, at cost, 1,984,450 shares at both June 30, 2003 and December 31, 2002	(12,765,709)	(12,765,709)
	<u> </u>	<u> </u>
Total stockholders' equity	23,064,744	23,231,888
	<u> </u>	<u> </u>
	\$ 26,354,456	\$ 26,481,207
	<u> </u>	<u> </u>

See accompanying notes

MEDSTONE INTERNATIONAL, INC.
CONSOLIDATED STATEMENTS OF INCOME
Three months ended June 30, 2003 and 2002
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenues:				
Procedures, maintenance fees and fee-for service	\$ 3,998,785	\$ 4,312,088	\$ 8,067,208	\$ 8,649,523
Net equipment sales	1,469,871	1,639,249	2,188,998	3,535,692
Interest income	37,952	79,521	78,453	161,644
Total revenues	5,506,608	6,030,858	10,334,659	12,346,859
Costs and expenses:				
Costs of procedures and maintenance fees	2,539,719	2,611,460	4,770,978	5,038,409
Cost of equipment sales	1,033,890	1,194,027	1,829,294	2,668,936
Research and development	495,903	313,971	904,964	574,910
Selling	785,988	794,030	1,403,021	1,606,245
General and administrative	730,805	833,731	1,532,924	1,651,221
Total costs and operating expenses	5,586,305	5,747,219	10,441,181	11,539,721
Operating income (loss)	(79,697)	283,639	(106,522)	807,138
Other expense (income)	(1,458)	4,153	22,362	2,266
Minority interests:				
Minority interest in subsidiaries income	179,255	160,511	349,636	330,530
Equity in loss (income) from unconsolidated subsidiary	(155,614)		(224,775)	30,359
Total minority interest	23,641	160,511	124,861	360,889
Income (loss) before provision for income taxes	(101,880)	118,975	(253,745)	443,983
Provision for (benefit from) income taxes	(39,700)	37,700	(69,900)	195,500
Net income (loss)	\$ (62,180)	\$ 81,275	\$ (183,845)	\$ 248,483
Net income (loss) per share:				
Basic	\$ (.02)	\$.02	\$ (.05)	\$.06
Diluted	N/A	\$.02	N/A	\$.06
Number of shares used in the computation of earnings (loss) per share:				
Basic	3,758,220	3,923,753	3,758,220	3,939,154
Diluted	N/A	3,927,685	N/A	3,940,437

See accompanying notes.

MEDSTONE INTERNATIONAL, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

	Common Stock		Additional paid-in capital	Accumulated earnings	Accumulated Other Comprehensive loss	Treasury Stock	Total
	Number of shares	Amount					
Balance at December 31, 2002	3,758,220	\$ 22,971	\$ 19,646,388	\$ 16,350,292	\$ (22,054)	\$ (12,765,709)	\$ 23,231,888
Net loss				(183,845)			(183,845)
Other comprehensive income:							
Unrealized loss on foreign currency translation, net					16,701		16,701
Total comprehensive loss							(167,144)
Balance at June 30, 2003 (Unaudited)	3,758,220	\$ 22,971	\$ 19,646,388	\$ 16,166,447	\$ (5,353)	\$ (12,765,709)	\$ 23,064,744

See accompanying notes.

MEDSTONE INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Six months ended June 30, 2003 and 2002

(Unaudited)

	2003	2002
Cash flows from operating activities:		
Net income (loss)	\$ (183,845)	\$ 248,483
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	826,709	890,172
Provision for doubtful accounts	120,000	120,000
Provision for inventory obsolescence	150,000	84,000
Minority interest in partnerships	349,636	330,530
Minority loss (equity) in unconsolidated subsidiary	(216,275)	30,359
Changes in assets and liabilities:		
Accounts receivable	(221,989)	103,212
Inventories	297,239	240,112
Prepaid expenses and other current assets	(300,161)	28,163
Accounts payable and accrued expenses	108,713	68,287
Accrued payroll expenses	(68)	82,042
Accrued income taxes		
Deferred revenue	(95,177)	(106,420)
Customer deposits	58,245	(257,868)
Other, net	17,005	(26,248)
Net cash provided by operating activities	910,032	1,834,824
Cash flows from investing activities:		
Purchase of short-term investments	(3,186,976)	(2,328,167)
Proceeds from sales of short-term investments	3,136,253	2,275,420
Investment in sales type lease		(7,860)
Distribution of minority interest	(374,000)	(424,000)
Purchase of property and equipment, net	(763,546)	(778,811)
Net cash used in investing activities	(1,188,269)	(1,263,418)
Cash flows from financing activities:		
Purchase of treasury stock		(870,052)
Deferral of rent payments	(6,956)	1,700
Net cash used in financing activities	(6,956)	(868,352)
Net decrease in cash and equivalents	(285,193)	(296,946)
Cash and equivalents at beginning of period	2,050,466	1,928,731
Cash and equivalents at end of period	\$ 1,765,273	\$ 1,631,785
Supplemental cash flow disclosures:		
Cash paid during the period for:		
Income taxes	\$ 21,548	\$ 37,528

See accompanying notes.

MEDSTONE INTERNATIONAL, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2003

A. Basis of presentation

The accompanying condensed consolidated financial statements include the accounts of Medstone International, Inc. and its subsidiaries (the Company). All significant intercompany transactions and accounts have been eliminated.

In the opinion of the Company's management, the accompanying unaudited condensed consolidated financial statements include all adjustments (which consist only of normal recurring adjustments) necessary for a fair presentation of its consolidated financial position at June 30, 2003 and consolidated results of operations and cash flows for the periods presented. Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These financial statements should be read in conjunction with the Company's audited financial statements included in the Company's 2002 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 31, 2003. Results of operations for the three and six months ended June 30, 2003 are not necessarily indicative of results to be expected for the full year.

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

B. Accumulated Other Comprehensive Loss:

The components of accumulated other comprehensive (loss)/income are as follows:

	Currency Translation Adjustment
Balance at December 31, 2002	\$ (22,054)
Foreign currency translation adjustments	16,701
Balance at June 30, 2003	\$ (5,353)

The functional currency of the investment in foreign subsidiary is considered to be the United States dollar.

The earnings associated with the Company's investment in its foreign subsidiary are considered to be permanently invested and no provision for U.S. federal and state income taxes on those earnings or translation adjustments has been provided.

For the three months ended June 30, 2003 and 2002, total comprehensive income/(loss) was \$(7,534) and \$65,602, respectively. For the six months ended June 30, 2003 and 2002, total comprehensive income/(loss) was \$(167,144) and \$203,093, respectively.

C. Business Segments

The Company operates in two business segments, equipment sales and fees for procedures, maintenance and management.

	Three Months Ended		Six Months Ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Revenue:	\$ 1,469,871	\$ 1,639,249	\$ 2,188,998	\$ 3,535,692
Equipment sales				
Fees for procedures, maintenance fees and fee-for-service	3,998,785	4,312,088	8,067,208	8,649,523
	<u>\$ 5,468,656</u>	<u>\$ 5,951,337</u>	<u>\$ 10,256,206</u>	<u>\$ 12,185,215</u>
Operating income (loss):				
Equipment sales	\$ (77,361)	\$ 109,059	\$ (452,329)	\$ (30,885)
Fees for procedures, maintenance fees and fee-for-service	(2,336)	174,580	345,807	838,023
	<u>\$ (79,697)</u>	<u>\$ 283,639</u>	<u>\$ (106,522)</u>	<u>\$ 807,138</u>

D. Per share information

Basic net income per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding. Diluted net income per share includes the effect of the potential shares outstanding, including dilutive stock options and warrants using the treasury stock method.

Common equivalent shares result from the assumed exercise of outstanding dilutive securities when applying the treasury stock method. Fully diluted per share information is not presented for periods in which the effect is antidilutive.

The following table sets forth the computation of earnings per share:

	Three Months Ended		Six Months Ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Numerator: Net income (loss)	\$ (62,180)	\$ 81,275	\$ (183,845)	\$ 248,483
Denominator for weighted average shares outstanding	3,758,220	3,923,753	3,758,220	3,939,154
Basic income (loss) per share	\$ (.02)	\$.02	\$ (.05)	\$.06
Effect of dilutive securities:				
Weighted average shares outstanding	N/A	3,923,753	N/A	3,939,154
Stock options	N/A	3,932	N/A	1,283
Denominator for diluted earnings per share	N/A	3,927,685	N/A	3,940,437
Diluted earnings per share	N/A	\$.02	N/A	\$.06

E. Inventories

Effective January 1, 2003, the Company changed its method of accounting for inventories from first-in first-out to an average cost method. The impact of this change was not material to the financial statements.

Inventories are stated at the lower of average cost or market and consist of the following:

	June 30, 2003	December 31, 2002
Raw materials	\$ 5,137,574	\$ 5,231,574
Work in process	321,432	312,665
Finished goods	1,325,759	1,538,777
Gross inventories	6,784,765	7,083,016
Less: Inventory reserves	(791,700)	(642,712)
Net inventories	\$ 5,993,065	\$ 6,440,304

F. Contingencies

From time to time, the Company is subject to legal actions and claims for personal injuries or property damage related to patients who use its products. The Company has obtained a liability insurance policy providing coverage for product liability and other claims. Management does not believe that the resolution of any current proceedings will have a material financial impact on the Company or the consolidated financial statements.

G. Stock Compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB 25) and related Interpretations in accounting for its employee stock options because, as discussed below, the alternative fair value accounting provided for under FASB Statement No. 123, *Accounting for Stock-Based Compensation*, requires the use of option valuation models that were not developed for use in valuing employee stock options. Under APB 25, because the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

In calculating pro forma information regarding net income (loss) and net income (loss) per share, as required by Financial Accounting Standards Board Statement No. 123, *Accounting for Stock-Based Compensation*, the fair value was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for the options on the Company's common stock for the three and six months ended June 30, 2003 and 2002, respectively: risk free interest rates of 3% and 4% in 2003 and 2002, respectively; dividend yields of 0% for all periods; volatility of the expected market prices of the Company's common stock of .324 for all periods; and expected life of the options of 5.5 years for all periods.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized over the options' vesting period. Had the Company's stock option and stock purchase plan been accounted for under SFAS No. 123, net income and earnings per share would have been reduced to the following pro forma amounts (*in thousands, except per share data*):

	Three Months ended		Six Months ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
Net income (loss):				
As reported	\$ (62)	\$ 81	\$ (184)	