SOMANETICS CORP
Form 10-Q
July 02, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

(x) Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended MAY 31, 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 0-19095

SOMANETICS CORPORATION
(Exact name of registrant as specified in its charter)

MICHIGAN	38-2394784
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1653 EAST MAPLE ROAD,
TROY, MICHIGAN
48083-4208
(Address of principal executive offices)
(Zip Code)

(248) 689-3050
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

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

Yes No X

Number of common shares outstanding at July 2, 2003: 9,080,363

PART I FINANCIAL INFORMATION

SOMANETICS CORPORATION

BALANCE SHEETS

ASSETS	May 31, 2003
	(Unaudited)
CURRENT ASSETS:	
Cash and cash equivalents	$ 1,895,510
Accounts receivable	1,254,261
Inventory	1,135,377
Prepaid expenses	126,874
Total current assets	4,412,023
PROPERTY AND EQUIPMENT (at cost):	
Machinery and equipment	1,893,554
Furniture and fixtures	248,657
Leasehold improvements	171,882
Total	2,314,093
Less accumulated depreciation and amortization	(1,725,050)
Net property and equipment	589,043
OTHER ASSETS:	
Intangible assets, net	963,294
Other	15,000
Total other assets	978,294
TOTAL ASSETS	$ 5,979,360
LIABILITIES AND SHAREHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Accounts payable	$ 571,198
Accrued liabilities	181,507
Total current liabilities	752,705
COMMITMENTS AND CONTINGENCIES	
SHAREHOLDERS' EQUITY:	
Preferred shares; authorized, 1,000,000 shares of $.01 par value; no shares issued or outstanding	-
Common shares; authorized, 20,000,000 shares of $.01 par value; issued and outstanding, 9,080,363 shares at May 31, 2003, and 9,077,863 shares at November 30, 2002	90,804
Additional paid-in capital	59,121,982
Accumulated deficit	(53,986,131)
Total shareholders' equity	5,226,655
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 5,979,360

See notes to financial statements

SOMANETICS CORPORATION

STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended May 31,		
	2003	2002	200
NET REVENUES................................	$ 2,203,442	$ 1,659,606	$ 4,15
COST OF SALES...............................	561,196	542,616	1,01
GROSS MARGIN................................	1,642,246	1,116,990	3,14
OPERATING EXPENSES:			
Research, development and engineering....	133,607	103,839	24
Selling, general and administrative......	1,644,016	1,422,685	3,23
Total operating expenses............	1,777,623	1,526,524	3,48
OPERATING LOSS..............................	(135,377)	(409,534)	(33
OTHER INCOME (EXPENSE):			
Interest expense........................	--	--	
Interest income.........................	6,004	20,281	1
Total other income..................	6,004	20,281	1
NET LOSS....................................	$ (129,373)	$ (389,253)	$ (32
NET LOSS PER COMMON SHARE- BASIC AND DILUTED.......................	$ (0.01)	$ (0.04)	$
WEIGHTED AVERAGE SHARES OUTSTANDING-BASIC AND DILUTED...........	9,080,363	9,077,863	9,07

See notes to financial statements

SOMANETICS CORPORATION

STATEMENTS OF CASH FLOWS
(UNAUDITED)

	For the Six Month Periods Ended	
	May 31, 2003	May 31, 2002
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (324,823)	$ (743,761)
Adjustments to reconcile net loss to net cash used in operations:		
Depreciation and amortization	119,206	108,829
Compensation expense for non-employee stock options	2,492	3,104
Changes in assets and liabilities:		
Accounts receivable (increase) decrease	(26,476)	294,894
Inventory (increase)	(131,072)	(332,140)
Prepaid expenses (increase)	(30,566)	(22,745)
Other assets decrease	--	12,078
Accounts payable increase (decrease)	100,318	(9,395)
Accrued liabilities increase (decrease)	(11,259)	41,537
Net cash (used in) operations	(302,180)	(647,599)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property and equipment (net)	(187,718)	(168,146)
Net cash (used in) investing activities	(187,718)	(168,146)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common shares	3,600	3,689,101
Net cash provided by financing activities	3,600	3,689,101
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(486,298)	2,873,356
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	2,381,808	167,873
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 1,895,510	$ 3,041,229
Supplemental Disclosure of Non cash investing activities:		
Issuance of warrants in connection with license acquisition (Note 2)	$ 44,793	

See notes to financial statements

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

MAY 31, 2003

1. FINANCIAL STATEMENT PRESENTATION

We prepared our unaudited interim financial statements pursuant to the Securities and Exchange Commission's rules. Accordingly, they do not include all of the information and footnotes normally included in our annual financial statements prepared in accordance with generally accepted accounting principles. We believe, however, that the disclosures are adequate to make the information presented not misleading.

The unaudited interim financial statements in this report reflect all adjustments which are, in our opinion, necessary to a fair statement of the results for the interim periods presented. All of these adjustments that are material are of a normal recurring nature. Our operating results for the six-month period ended May 31, 2003 do not necessarily indicate the results that you should expect for the year ending November 30, 2003. You should read the unaudited interim financial statements together with the financial statements and related footnotes for the year ended November 30, 2002 included in our Annual Report on Form 10-K for the fiscal year ended November 30, 2002.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Inventory is stated at the lower of cost or market on a first-in, first-out (FIFO) basis. Inventory consists of:

	May 31, 2003	November 30, 2002
Finished goods..................	$ 321,258	$ 410,133
Work in process.................	257,909	154,816
Purchased components............	556,210	439,356
Total......................	$ 1,135,377	$ 1,004,305

Intangible Assets consist of patents and trademarks, and license acquisition costs. Patents and trademarks are recorded at cost and are being amortized on the straight-line method over 17 years. The carrying amount and accumulated amortization of these patents and trademarks is as follows:

	May 31, 2003	November 30, 2002
Patents and trademarks	111,733	111,733
Less accumulated amortization ...	(77,532)	(74,076)
Total	$ 34,201	$ 37,657

Amortization expense for the three months ended May 31, 2003 and May 31, 2002 was approximately $1,700. Amortization expense for the six months ended May 31, 2003 and May 31, 2002 was approximately $3,500. Amortization expense for each of the next five fiscal years is expected to be approximately $6,900 per year.

License acquisition costs are related to our acquisition of exclusive, worldwide, royalty-bearing licenses to specified rights relating to the CorRestore(TM) System, and related products and accessories. The total carrying amount of these license acquisition costs is as follows:

	May 31, 2003	November 30, 2002
License acquisition costs........	$ 929,093	$ 884,300

Effective April 25, 2003, in connection with our receipt of CE Mark certification for the CorRestore System, an additional 50,000 warrants to purchase common shares vested for CorRestore LLC and its agent, Wolfe & Company. We estimated the value of these warrants as part of our license acquisition costs using the Black-Scholes valuation model with the following assumptions: expected volatility (the measure by which the stock price has fluctuated or is expected to fluctuate during the period) 64.70%, risk-free interest rate of 2.0%, expected life of 25 months and dividend yield of 0%.

License acquisition costs are intangible assets with indefinite lives that are reviewed annually for impairment and whenever events or changes in circumstances indicate that the carrying value of the asset may not be recovered.

Stock Options In October 1995, Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," was issued by the Financial Accounting Standards Board. In addition, in December 2002, Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation -- Transition and Disclosure," was issued by the Financial Accounting Standards Board, and amends Statement No. 123. Statement No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation. In addition, Statement No. 148 amends the disclosure requirements of Statement No. 123 regardless of the accounting method used to account for stock-based compensation. We have chosen to continue to account for stock-based compensation of employees using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. We have also adopted the enhanced disclosure provisions as defined by Statement No. 148 beginning with our fiscal quarter ended February 28, 2003.

During the first two quarters of fiscal 2003, we granted 39,000 stock options to our employees and directors, and one of our employees exercised stock options to purchase 2,500 newly-issued common shares. During the first two quarters of fiscal 2002 we granted 409,500 stock options to our employees and directors, and one of our former employees exercised stock options to purchase 2,833 newly-issued common shares.

	FOR THE SIX MONTHS ENDED MAY 31, 2003	2002
Net loss	$ 324,823	$ 743,761
Pro-forma net loss, had fair value method been applied	$ 614,127	$ 1,019,554
Net loss per common share-basic and diluted	(.04)	(.08)
Pro-forma net loss per common share-basic and diluted, had fair value method been applied	(.07)	(.12)
Stock-based employee compensation included in actual net loss	$ 2,492	$ 3,104
Pro-forma stock-based employee compensation, had fair value method been applied	$ 289,304	$ 275,793

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

MAY 31, 2003

Loss Per Common Share - basic and diluted is computed using the weighted average number of common shares outstanding during each period. Common shares issuable under stock options and warrants have not been included in the computation of the net loss per common share - diluted, because such inclusion would be antidilutive. As of May 31, 2003 and May 31, 2002, we had outstanding warrants and options to purchase common shares of 5,186,833 and 5,070,050, respectively.

Accounting Pronouncements During the first quarter of fiscal 2003, we adopted Financial Accounting Standards Board Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." The adoption of this interpretation statement had no impact on our financial statements.

3. ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	May 31, 2003	November 30, 2
Incentive Compensation	$ 99,367	$ 8,000
Insurance	28,118	34,464
Sales commissions	24,312	55,381
Royalty	23,210	12,071
Warranty	6,500	6,400
Clinical Research	--	21,450
Professional fees	--	15,000
Training	--	40,000
Total	$181,507	$192,766

4. COMMITMENTS AND CONTINGENCIES

We may become subject to products liability claims by patients or physicians, and may become a defendant in products liability or malpractice litigation. We have obtained products liability insurance and an umbrella policy. We might not be able to maintain such insurance or such insurance might not be sufficient to protect us against products liability.

5. COMMON STOCK

Effective January 23, 2003, we granted 10-year options under the 1997 Stock Option Plan to purchase 11,500 common shares, to two of our employees at an exercise price of $1.70 per share (the closing sale price of the common shares as of the date of grant).

In February 2003, one of our employees exercised stock options to purchase 2,500 newly-issued common shares.

Effective March 24, 2003, we granted 10-year options under the 1997 Stock Option Plan to purchase 10,000 common shares, to one of our employees at an exercise price of $1.76 per share (the closing sale price of the common shares as of the date of grant).

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

MAY 31, 2003

On April 10, 2003, our shareholders approved an amendment to the Somanetics Corporation 1997 Stock Option Plan to increase the number of common shares reserved for issuance pursuant to the exercise of options granted under the 1997 Plan by 450,000 shares, from 2,110,000 to 2,560,000 shares. In addition, effective April 10, 2003, we granted to five of our directors, who are not officers or employees, 10-year options under the 1997 Stock Option Plan to purchase an aggregate of 17,500 common shares at an exercise price of $2.80 per share (the closing sale price of the common shares as of the date of grant).

6. SEGMENT INFORMATION

We operate our business in one reportable segment, the development, manufacture and marketing of medical devices. Each of our two product lines have similar characteristics, customers, distribution and marketing strategies, and are subject to similar regulatory requirements. In addition, in making operating and strategic decisions, our management evaluates net revenues based on the worldwide net revenues of each major product line, and profitability on an enterprise-wide basis due to shared costs. Approximately 89% of our net revenues in the first two quarters of fiscal 2003 were derived from our INVOS Cerebral Oximeter product line, compared to 97% of our net revenues in the first two quarters of fiscal 2002.

7. NOTES PAYABLE -- BANK LINE OF CREDIT

As of April 24, 2003, we amended our Loan and Security Agreement with Crestmark Bank. Pursuant to the amendment, we paid a $5,000 renewal commitment fee to continue our lending relationship for the remainder of 2003. We must negotiate a new lending relationship if we would like to continue the lending relationship into 2004. Pursuant to the amendment, we also agreed to give the bank at least 30 days advance notice of any intended draw on our line of credit.

SOMANETICS CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS

MAY 31, 2003

Some of the statements in this report are forward-looking statements. These forward-looking statements include statements relating to our performance in this Management's Discussion and Analysis of Financial Condition and Results of Operations. Forward-looking statements include statements regarding the intent, belief or current expectations of us or our officers, including statements preceded by, followed by or including forward-looking terminology such as "may," "will," "should," "believe," "expect," "anticipate," "estimate," "continue," "predict" or similar expressions, with respect to various matters.

Our actual results might differ materially from those projected in the forward-looking statements depending on various important factors. These important factors include our history of losses and ability to continue as a going concern, our current dependence on the Cerebral Oximeter and SomaSensor, the challenges associated with developing new products, the uncertainty of acceptance of our products by the medical community, the lengthy sales cycle for our products, competition in our markets, our dependence on our distributors, and the other factors discussed under the caption "Risk Factors" and elsewhere in our Registration Statement on Form S-1 (file no. 333-74788) effective January 11, 2002 and elsewhere in this report, all of which constitute cautionary statements identifying important factors with respect to the forward-looking statements, including risks and uncertainties, that could cause actual results to differ materially from those in the forward-looking statements.

All forward-looking statements in this report are based on information available to us on the date of this report. We do not undertake to update any forward-looking statements that may be made by us or on our behalf in this report or otherwise.

RESULTS OF OPERATIONS

OVERVIEW

We develop, manufacture and market the INVOS Cerebral Oximeter, the only non-invasive patient monitoring system commercially available in the United States that continuously measures changes in the blood oxygen level in the brain. We also develop and market the CorRestore System for use in cardiac repair and reconstruction, including heart surgeries called surgical ventricular restoration, or SVR.

During fiscal 2002 and the first two quarters of fiscal 2003, our primary activities consisted of sales and marketing of the Cerebral Oximeter, the related disposable SomaSensor, and the CorRestore System.

We derive our revenues from sales of Cerebral Oximeters and SomaSensors to our distributors, and from sales of Cerebral Oximeters, SomaSensors and CorRestore Systems to hospitals in the United States through our direct sales employees and independent sales representatives. We offer to our customers a no-cap sales program whereby we ship the Cerebral Oximeter to the customer at no charge, in exchange for the customer agreeing to purchase at a premium a minimum monthly quantity of SomaSensors. Payment terms are generally net 30 days for United States sales and net 60 days or longer for international sales. Our primary expenses, excluding the cost of our products, are selling, general and administrative and research, development and engineering.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS

MAY 31, 2003

THREE MONTHS ENDED MAY 31, 2003 COMPARED TO THREE MONTHS ENDED MAY 31, 2002

Our net revenues increased approximately $544,000, or 33%, from $1,659,606 in the three-month period ended May 31, 2002 to $2,203,442 in the three-month period ended May 31, 2003. The increase in net revenues is primarily attributable to:

- an increase in United States sales of approximately $516,000, from approximately $1,296,000 in the second quarter of fiscal 2002 to approximately $1,812,000 in the second quarter of fiscal 2003. This increase is primarily due to an increase in sales of the disposable SomaSensor of approximately $313,000, or 29%, and an increase in CorRestore System revenues of approximately $187,000, or 415%, and
- a 13% increase in the average selling price of SomaSensors in the United States, primarily due to the increase in the suggested retail price of the SomaSensor effective December 1, 2002. This increase was partially offset by increased SomaSensor sales to international distributors, which have lower average selling prices, and
- an increase in international sales of approximately $28,000, from approximately $363,000 in the second quarter of fiscal 2002 to approximately $391,000 in the second quarter of fiscal 2003. This increase is primarily due to increased purchases by Tyco Healthcare.

Approximately 18% of our net revenues in the second quarter of fiscal 2003 were export sales, compared to approximately 22% of our net revenues in the second quarter of fiscal 2002. Sales of our products as a percentage of net revenues were as follows:

	PERCENT OF NET REVENUE SECOND QUARTER OF FISCAL	
PRODUCT	2003	2002
SomaSensors	72%	76%
Cerebral Oximeters	17%	21%
CorRestore Systems	11%	3%
Total	100%	100%

One international distributor accounted for approximately 15% of net revenues for the three months ended May 31, 2003, and approximately 12% of net revenues for the three months ended May 31, 2002.

SOMANETICS CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

MAY 31, 2003

Gross margin as a percentage of net revenues was approximately 75% for the quarter ended May 31, 2003 and approximately 67% for the quarter ended May 31, 2002. The increase in gross margin as a percentage of net revenues is primarily attributable to:

- the increase in the average selling price of SomaSensors described above,
- sales of our latest model SomaSensor, which is less costly to manufacture than the prior model SomaSensor sold in the second quarter of fiscal 2002,
- a change in the sales mix to increased sales in the United States, which have higher gross margins than international sales, and
- a change in the sales mix to increased sales of CorRestore Systems, which have higher gross margins than Cerebral Oximeters.

Our research, development and engineering expenses increased approximately $30,000, or 29%, from $103,839 for the three months ended May 31, 2002 to $133,607 for the three months ended May 31, 2003. The increase is primarily attributable to approximately $47,000 in development costs associated with the CorRestore System, partially offset by approximately $21,000 in decreased costs associated with the Cerebral Oximeter.

Selling, general and administrative expenses increased approximately $221,000, or 16%, from $1,422,685 for the three months ended May 31, 2002 to $1,644,016 for the three months ended May 31, 2003. The increase in selling, general and administrative expense is primarily attributable to:

- a $59,000 increase in selling-related, promotional, and trade show expenses as a result of our increased sales and marketing activities,
- a $55,000 increase in accrued incentive compensation expense, primarily due to our executive officers participating in the 2003 Incentive Compensation Plan after not participating in fiscal 2002,
- a $51,000 increase in salaries, wages, commissions and related expenses, primarily as a result of an increase in the number of employees, principally sales and marketing (from an average of 28 employees for the second quarter of fiscal 2002 to an average of 30 employees for the second quarter of fiscal 2003),
- a $42,000 increase in commissions paid to our independent sales representatives as a result of increased sales,
- $26,000 in costs associated with our national sales meeting held in May 2003,
- a $22,000 increase in regulatory expenses as a result of our ISO 9001 re-certification audit conducted in April 2003, and
- a $19,000 increase in royalty expense as a result of increased sales of the CorRestore System.

These increases were partially offset by a decrease in bad debts expense of approximately $23,000.

For the three-month period ended May 31, 2003, we realized a 67% decrease in our net loss over the same period in fiscal 2002. The decrease is primarily attributable to:

- a 33% increase in net revenues, and
- an 8% increase in gross margin percentage.

The reduction in our net loss was achieved despite a 16% increase in operating expenses.

SOMANETICS CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

MAY 31, 2003

SIX MONTHS ENDED MAY 31, 2003 COMPARED TO SIX MONTHS ENDED MAY 31, 2002

Our net revenues increased approximately $903,000, or 28%, from $3,251,426 in the six-month period ended May 31, 2002 to $4,154,388 in the six-month period ended May 31, 2003. The increase in net revenues is primarily attributable to:

- an increase in United States sales of approximately $951,000, from approximately $2,513,000 in the first two quarters of fiscal 2002 to approximately $3,464,000 in the first two quarters of fiscal 2003. This increase is primarily due to an increase in sales of the disposable SomaSensor of approximately $706,000, or 35%, and an increase in CorRestore System revenues of approximately $358,000, or 373%. This increase was partially offset by a decrease in sales of the Cerebral Oximeter of approximately $113,000, or 29%, primarily as a result of a preference by larger U.S. hospitals to acquire Cerebral Oximeters using our no-cap sales program, and
- a 13% increase in the average selling price of SomaSensors in the United States primarily due to the increase in the suggested retail price of the SomaSensor effective December 1, 2002. This increase was partially offset by increased SomaSensor sales to international distributors, which have lower average selling prices.

The increase in net revenues was achieved despite a decrease in international sales of approximately $48,000, from approximately $738,000 in the first two quarters of fiscal 2002 to approximately $690,000 in the first two quarters of fiscal 2003, primarily attributable to decreased purchases by Tyco Healthcare.

Approximately 17% of our net revenues in the first two quarters of fiscal 2003 were export sales, compared to approximately 23% of our net revenues in the first two quarters of fiscal 2002. Sales of our products as a percentage of net revenues were as follows:

	PERCENT OF NET REVENUE FIRST TWO QUARTERS OF FISCAL	
PRODUCT	2003	2002
SomaSensors	74%	71%
Cerebral Oximeters	15%	26%
CorRestore Systems	11%	3%

Total.........................	100%	100%

One international distributor accounted for approximately 11% of net revenues for the six months ended May 31, 2003, and approximately 12% of net revenues for the six months ended May 31, 2002.

12

SOMANETICS CORPORATION

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

MAY 31, 2003

Gross margin as a percentage of net revenues was approximately 76% for the six months ended May 31, 2003 and approximately 68% for the six months ended May 31, 2002. The increase in gross margin as a percentage of net revenues is primarily attributable to:

- the increase in the average selling price of SomaSensors described above,

- sales of our latest model SomaSensor, which is less costly to manufacture than the prior model SomaSensor sold in the first two quarters quarter of fiscal 2002,

- a change in the sales mix to increased sales of SomaSensors and CorRestore Systems, which have higher gross margins than Cerebral Oximeters, and

- a change in the sales mix to increased sales in the United States, which have higher gross margins than international sales.

Our research, development and engineering expenses decreased approximately $41,000, or 14%, from $283,442 for the six months ended May 31, 2002 to $242,779 for the six months ended May 31, 2003. The decrease is primarily attributable to approximately $45,000 in decreased costs associated with the development of the CorRestore System.

Selling, general and administrative expenses increased approximately $538,000, or 20%, from $2,701,007 for the six months ended May 31, 2002 to $3,238,948 for the six months ended May 31, 2003. The increase in selling, general and administrative expense is primarily attributable to:

- a $112,000 increase in salaries, wages, commissions and related expenses, primarily as a result of an increase in the number of employees, principally sales and marketing (from an average of 28 employees for the six months ended May 31, 2002 to an average of 29 employees for the six months ended May 31, 2003),
- a $109,000 increase in accrued incentive compensation expense, primarily due to our executive officers participating in the 2003 Incentive Compensation Plan after not participating in fiscal

2002,

- a $107,000 increase in selling-related, promotional, and trade show expenses as a result of our increased sales and marketing activities,
- a $105,000 increase in customer education expenses for the CorRestore System,
- a $73,000 increase in commissions paid to our independent sales representatives as a result of increased sales, and
- a $36,000 increase in royalty expense as a result of increased sales of the CorRestore System.

These increases were partially offset by a $31,000 decrease in insurance expenses, primarily as a result of a policy premium refund for our 2002 products liability insurance coverage.

For the six-month period ended May 31, 2003, we realized a 56% decrease in our net loss over the same period in fiscal 2002. The decrease is primarily attributable to:

- a 28% increase in net revenues, and
- an 8% increase in gross margin percentage.

The reduction in our net loss was achieved despite a 17% increase in operating expenses.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operations during the six-month period ended May 31, 2003 was approximately $302,000. Cash was used primarily to:

- fund our net loss, primarily selling, general and administrative expenses and research, development and engineering expenses, totaling approximately $206,000, before depreciation and amortization expense,
- increase inventories by approximately $131,000, primarily as a result of the acquisition of components associated with our next generation Cerebral Oximeter,
- increase prepaid expenses by approximately $31,000, primarily due to the renewal of our products liability insurance coverage in December 2002,
- increase accounts receivable by approximately $26,000, primarily because of higher second quarter 2003 sales than fourth quarter 2002 sales, partially offset by more timely collections in fiscal 2003, and
- decrease accrued liabilities by approximately $11,000, primarily due to payments made in fiscal 2003 and reduced sales commissions, partially offset by increased accrued incentive compensation expense as a result of our executive officers participating in the 2003 Incentive Compensation Plan after not participating in fiscal 2002.

These uses of cash were partially offset by an increase in accounts payable of approximately $100,000, primarily due to increased purchases of inventories.

We expect our working capital requirements to increase if sales increase.

Capital expenditures in the first six months of fiscal 2003 were approximately $188,000. These expenditures were primarily for Cerebral Oximeter demonstration units and no-cap sales units.

We have a Loan and Security Agreement with Crestmark Bank for a working capital line of credit for up to $750,000, collateralized by all of our assets. Under the agreement, Crestmark Bank may, but is not obligated to, lend us amounts we request from time to time, up to $750,000, if no default exists. The loans are limited by a borrowing base based on qualifying accounts receivable and lender reserves. The loan is payable on demand, and our collections of our receivables are directed to Crestmark Bank in payment of any outstanding balance of the loan. The principal amount outstanding bears interest, payable monthly, at the prime rate (4.00% as of June 30, 2003) plus 2% plus a 2.4% service fee. As of June 30, 2003, we had no outstanding principal loan balance and approximately $750,000 was available for borrowing, at Crestmark's discretion, under the facility. Effective April 24, 2003, we amended our Loan and Security Agreement with Crestmark Bank. Pursuant to the amendment, we paid a $5,000 renewal commitment fee to continue our lending relationship for the remainder of 2003. We must negotiate a new lending relationship if we would like to continue the lending relationship into 2004. Pursuant to the amendment, we also agreed to give the bank at least 30 days advance notice of any intended draw on our line of credit.

As of May 31, 2003, we had working capital of $3,659,318, cash and cash equivalents of $1,895,510, total current liabilities of $752,705 and shareholder's equity of $5,226,655. We had an accumulated deficit of $53,986,131 through May 31, 2003.

We believe that the cash and cash equivalents on hand at May 31, 2003, together with the estimated net borrowings available under the Crestmark Bank Loan and Security Agreement, will be adequate to satisfy our operating and capital requirements for more than the next twelve months.

The estimated length of time current cash, cash equivalents and available borrowings will sustain our operations is based on estimates and assumptions we have made. These estimates and assumptions are subject to change as a result of actual experience. Actual capital requirements necessary to market the Cerebral Oximeter and SomaSensor, to develop and market the CorRestore System, to undertake other product development activities, and for working capital might be substantially greater than current estimates.

CRITICAL ACCOUNTING POLICIES

We believe our most significant accounting policies relate to the recording of an intangible asset for license acquisition costs related to our acquisition of exclusive, worldwide, royalty-bearing licenses to specified rights relating to the CorRestore System and related products and accessories, and our accounting treatment of stock options issued to employees.

In fiscal years 2000, 2001 and 2003, we recorded an intangible asset related to our acquisition of exclusive, worldwide, royalty-bearing licenses to specified rights relating to the CorRestore System and related products and accessories. License acquisition costs included our estimate of the fair value of ten-year vested stock options to purchase common shares granted to one of our directors in connection with negotiating and assisting us in completing the transaction, and our estimate of the fair value of the vested portion of five-year warrants to purchase common shares issued in the transaction.

We estimated the value of the stock options to purchase common shares and the warrants to purchase common shares using the Black-Scholes valuation model. The Black-Scholes valuation model requires the following assumptions: expected life period of the security, expected volatility of our stock price during the period, risk-free interest rate, and dividend yield. Given the assumptions inherent in the Black-Scholes valuation model, it would have been possible to calculate a different value for our intangible asset by changing one or more of the valuation model variables or by using a different valuation model. However, we believe that the model is appropriate, that the judgments and assumptions that we made at the time of valuation were also appropriate, and that the reported results would not have been materially different had one or more of the variables been different or had a different valuation model been used.

We have adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets." This statement establishes accounting and reporting standards for goodwill and other intangible assets. The effect of adopting this Statement has been to discontinue amortizing our license acquisition costs related to our acquisition of exclusive, worldwide, royalty-bearing licenses to specified rights relating to the CorRestore System and related products and accessories described above because we believe these licenses have an indefinite life. Therefore, no amortization expense has been recorded related to these license acquisition costs since December 1, 2001, the date we adopted Statement No. 142.

In October 1995, Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," was issued by the Financial Accounting Standards Board. In addition, in December 2002, Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation -- Transition and Disclosure," was issued by the Financial Accounting Standards Board, and amends Statement No. 123. We have chosen to continue to account for stock-based compensation of employees using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, compensation costs for stock options granted to employees are measured as the excess, if any, of the market price of our stock at the date of the grant over the amount an employee must pay to acquire the stock. No compensation expense has been charged against income for stock option grants to employees because our stock option grants are priced at the market value as of the date of grant. During the first two quarters of fiscal 2003, we granted 39,000 stock options to our employees and directors.

Had we recognized compensation expense for stock options granted to employees in the first six months of fiscal 2003, using the fair value method of accounting based on the fair value of the options on the grant date using the Black-Scholes valuation model, our net loss, on a pro forma basis, would have increased by approximately $289,000, or $.03 per common share. Had we recognized compensation expense for our stock options granted to employees in the first six months of fiscal 2002, using the fair value method of accounting based on the fair value of the options on the grant date using the Black-Scholes valuation model, our net loss, on a pro forma basis, would have increased by approximately $276,000, or $.04 per common share.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4. CONTROLS AND PROCEDURES

The Company, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures within 90 days of the filing date of this quarterly report, and, based on their evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective. There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

Disclosure controls and procedures are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

PART II OTHER INFORMATION

Item 4. Submission of Matters to a Vote of Security Holders

Our Annual Meeting of Shareholders was held on April 10, 2003. At the Annual Meeting, Daniel S. Follis and Robert R. Henry were elected as directors and the terms of office of Bruce J. Barrett, A. Brean Murray, Dr. James I. Ausman, and Joe B. Wolfe as directors continued after the meeting. H. Raymond Wallace retired from our Board as of the Annual Meeting date. 8,074,911 votes were cast for Mr. Follis' election and 168,383 votes were withheld from Mr. Follis' election, and 8,072,211 votes were cast for Mr. Henry's election and 171,083 votes were withheld from Mr. Henry's election. There were no abstentions or broker non-votes in connection with the election of the directors at the Annual Meeting.

In addition, at the Annual Meeting of Shareholders, the shareholders approved an amendment to the Somanetics Corporation 1997 Stock Option Plan to increase the number of common shares reserved for issuance pursuant to the exercise of options granted under the 1997 Plan by 450,000 shares, from 2,110,000 to 2,560,000 shares. 7,318,371 votes were cast in favor of this proposal, 807,732 votes were cast against this proposal, and 117,191 votes abstained on this proposal. There were no broker non-votes in connection with the amendment to the 1997 Stock Option plan at the Annual Meeting.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

10.1 Amendment to Crestmark Loan and Security Agreement, dated April 24, 2003.

99.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

99.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

No reports on Form 8-K were filed by us during the quarter for which this report is filed.

SIGNATURES

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

Somanetics Corporation

(Registrant)

Date: July 2, 2003

By:/s/ William M. Iacona
William M. Iacona
Vice President, Finance, Controller, and Treasurer (Duly Authorized and Principal Financial Officer)

CERTIFICATIONS

I, Bruce J. Barrett, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Somanetics Corporation;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: July 2, 2003

/s/ Bruce J. Barrett

Bruce J. Barrett, President and
Chief Executive Officer

CERTIFICATIONS

I, William M. Iacona, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Somanetics Corporation;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: July 2, 2003

/s/ William M. Iacona

William M. Iacona, Vice
President, Finance, Controller,
and Treasurer

22

EXHIBIT INDEX

Exhibit	Description
10.1	Amendment to Crestmark Loan and Security Agreement, dated April 24, 2003.
99.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.