

Edgar Filing: SOMANETICS CORP - Form 10-Q

SOMANETICS CORP  
Form 10-Q  
October 07, 2004

UNITED STATES  
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 AUGUST 31, 2004

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 October 7, 2004: 10,134,782

PART I FINANCIAL INFORMATION

SOMANETICS CORPORATION

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BALANCE SHEETS

	August 31, 2004	November 2003
	----- (Unaudited)	----- (Audited)
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents .....	\$ 6,341,338	\$ 2,200,000
Accounts receivable .....	1,750,359	2,000,000
Inventory .....	776,816	1,000,000
Prepaid expenses .....	105,583	1,000,000
	-----	-----
Total current assets .....	8,974,096	5,400,000
	-----	-----
<b>PROPERTY AND EQUIPMENT (at cost):</b>		
Machinery and equipment .....	2,457,129	2,000,000
Furniture and fixtures .....	252,971	2,000,000
Leasehold improvements .....	171,882	1,000,000
	-----	-----
Total .....	2,881,982	2,400,000
Less accumulated depreciation and amortization .....	(1,868,431)	(1,700,000)
	-----	-----
Net property and equipment .....	1,013,551	700,000
	-----	-----
<b>OTHER ASSETS:</b>		
Intangible assets, net .....	954,654	900,000
Other .....	15,000	1,000,000
	-----	-----
Total other assets .....	969,654	900,000
	-----	-----
<b>TOTAL ASSETS .....</b>	<b>\$ 10,957,301</b>	<b>\$ 7,100,000</b>
	=====	=====
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable .....	\$ 515,486	\$ 600,000
Accrued liabilities .....	368,528	300,000
	-----	-----
Total current liabilities .....	884,014	900,000
	-----	-----
<b>COMMITMENTS AND CONTINGENCIES .....</b>		
<b>SHAREHOLDERS' EQUITY:</b>		
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, 10,134,782 shares at August 31, 2004, and 9,298,669 shares at November 30, 2003 .....	101,348	59,600
Additional paid-in capital .....	62,318,465	59,600
Accumulated deficit .....	(52,346,526)	(53,500)
	-----	-----
Total shareholders' equity .....	10,073,287	6,100,000
	-----	-----
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY .....</b>	<b>\$ 10,957,301</b>	<b>\$ 7,100,000</b>
	=====	=====

See notes to financial statements

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SOMANETICS CORPORATION

STATEMENTS OF OPERATIONS  
(Unaudited)

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2004	2003	2004	2003
NET REVENUES .....	\$ 3,076,373	\$2,303,880	\$ 8,779,614	\$ 6,450,000
COST OF SALES .....	443,837	519,545	1,483,546	1,530,000
GROSS MARGIN .....	2,632,536	1,784,335	7,296,068	4,920,000
OPERATING EXPENSES:				
Research, development and engineering ...	87,001	85,435	269,418	320,000
Selling, general and administrative .....	2,019,128	1,628,322	5,810,669	4,860,000
Total operating expenses .....	2,106,129	1,713,757	6,080,087	5,190,000
OPERATING INCOME (LOSS) .....	526,407	70,578	1,215,981	(260,000)
OTHER INCOME:				
Interest income .....	13,315	4,876	26,216	10,000
Total other income .....	13,315	4,876	26,216	10,000
NET INCOME (LOSS) .....	\$ 539,722	\$ 75,454	\$ 1,242,197	\$ (250,000)
NET INCOME (LOSS) PER COMMON SHARE - BASIC .....	\$ 0.05	\$ 0.01	\$ 0.13	\$ (0.04)
NET INCOME (LOSS) PER COMMON SHARE - DILUTED .....	\$ 0.05	\$ 0.01	\$ 0.11	\$ (0.04)
WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC .....	10,098,237	9,101,397	9,662,716	9,080,000
WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED .....	11,913,495	9,700,387	11,353,955	9,080,000

See notes to financial statements

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SOMANETICS CORPORATION

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STATEMENTS OF CASH FLOWS  
(UNAUDITED)

	For the Nine Month Periods Ended	
	August 31, 2004	August 31, 2003
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income (loss) .....	\$ 1,242,197	\$ (249,368)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operations:		
Depreciation and amortization .....	199,317	176,619
Compensation expense for non-employee stock options .....	--	7,224
Changes in assets and liabilities:		
Accounts receivable (increase) decrease .....	268,256	(172,333)
Inventory (increase) decrease .....	313,445	(168,116)
Prepaid expenses (increase) decrease .....	17,620	(8,090)
Accounts payable increase (decrease) .....	(125,746)	82,219
Accrued liabilities increase (decrease) .....	18,981	(4,126)
Net cash provided by (used in) operations .....	1,934,070	(335,971)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Acquisition of property and equipment (net) .....	(497,946)	(307,620)
Net cash (used in) investing activities .....	(497,946)	(307,620)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from issuance of common shares due to exercise of stock options and warrants .....	2,666,022	167,724
Net cash provided by financing activities .....	2,666,022	167,724
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS .....</b>	<b>4,102,146</b>	<b>(475,867)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD .....</b>	<b>2,239,192</b>	<b>2,381,808</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD .....</b>	<b>\$ 6,341,338</b>	<b>\$ 1,905,941</b>
<b>Supplemental Disclosure of Non cash investing activities:</b>		
Issuance of warrants in connection with license acquisition (Note 2) .....		\$ 44,793

See notes to financial statements

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SOMANETICS CORPORATION

## NOTES TO FINANCIAL STATEMENTS (UNAUDITED)

AUGUST 31, 2004

### 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 notes 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 nine-month period ended August 31, 2004 do not necessarily indicate the results that you should expect for the year ending November 30, 2004. You should read the unaudited interim financial statements together with the financial statements and related notes for the year ended November 30, 2003 included in our Annual Report on Form 10-K for the fiscal year ended November 30, 2003.

### 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:

	August 31, 2004	November 30, 2003
	-----	-----
Finished goods.....	\$ 403,191	\$ 354,024
Work in process.....	26,680	173,193
Purchased components.....	346,945	563,044
	-----	-----
Total.....	\$ 776,816	\$ 1,090,261
	=====	=====

Property and Equipment are stated at cost. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets, which range from two to five years. We offer to our United States 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 SomaSensors. The Cerebral Oximeters that are shipped to our customers are classified as property and equipment and are depreciated over five years. During the first three quarters of fiscal 2004, we capitalized approximately \$405,000 in costs for Cerebral Oximeters being used as demonstration and no-cap units, and during the first three quarters of fiscal 2003 we capitalized approximately \$257,000 in costs for such units. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the net book value of the asset may not be recovered.

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 are as follows:

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	August 31, 2004	November 30, 2003
	-----	-----
Patents and trademarks.....	111,733	111,733
Less accumulated amortization.....	(86,172)	(80,988)
	-----	-----
Total.....	\$ 25,561	\$ 30,745
	=====	=====

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SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS  
(UNAUDITED)

AUGUST 31, 2004

Amortization expense for the nine months ended August 31, 2004 and August 31, 2003 was approximately \$5,200. Amortization expense for each of the next four fiscal years is expected to be approximately \$6,900 per year, and approximately \$3,100 in fiscal 2008.

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:

	August 31, 2004	November 30, 2003
	-----	-----
License acquisition costs .....	\$ 929,093	\$ 929,093

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 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. However, we have also adopted the enhanced disclosure provisions as defined by Statement No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure." During the first three quarters of fiscal 2004 and fiscal 2003, we granted 50,500 and 471,000 stock options, respectively, to our employees and directors, and we issued 318,276 and 74,171 newly-issued common shares, respectively, as a result of stock option exercises.

FOR THE THREE MONTHS ENDED  
AUGUST 31,                      AUGUST 31,  
-----

FOR THE NINE MONTHS ENDED  
AUGUST 31,                      A  
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	2004 -----	2003 -----	2004 -----
Net income (loss) .....	\$ 539,722	\$ 75,454	\$ 1,242,197
Add: Stock-based employee compensation included in actual net income (loss).....	\$ 0	\$ 4,732	\$ 0
Deduct: Total stock-based employee compensation expense, had fair value method been applied .....	\$ (197,198)	\$ (243,487)	\$ (566,590)
	-----	-----	-----
Pro-forma net income (loss) .....	\$ 342,524	\$ (163,301)	\$ 675,607
	=====	=====	=====
Net income (loss) per common share - diluted .....	\$ .05	\$ .01	\$ .11
Pro forma net income (loss) per common share - diluted .....	\$ .03	\$ (.02)	\$ .06

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SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS  
(UNAUDITED)

AUGUST 31, 2004

Net Income (Loss) Per Common Share - basic and diluted is computed using the weighted average number of common shares outstanding during each period. Weighted average shares outstanding - diluted, for the three and nine months ended August 31, 2004, includes the potential dilution that could occur for common stock issuable under stock options or warrants. For the three and nine months ended August 31, 2004, the difference between weighted average shares - diluted and weighted average shares - basic is calculated as follows:

	Three Months -----	Nine Months -----
Weighted average shares - basic	10,098,237	9,662,716
Add: effect of dilutive common shares and warrants	1,815,258	1,691,239
	-----	-----
Weighted average shares - diluted	11,913,495	11,353,955

For the three months ended August 31, 2003, the difference between weighted average shares - diluted and weighted average shares - basic is calculated as follows:

	Three Months -----
Weighted average shares - basic	9,101,397
Add: effect of dilutive common shares and warrants	598,990
	-----
Weighted average shares - diluted	9,700,387

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Common shares issuable under stock options and warrants have not been included in the computation of net loss per common share - diluted for the nine months ended August 31, 2003, because such inclusion would be antidilutive. For the three and nine months ended August 31, 2004, there were approximately 22,000 stock options outstanding that were excluded from the computation of net income per common share - diluted, as the exercise price of these options exceeded the average price per share of our common shares. In addition, there were approximately 1,866,000 warrants outstanding that were excluded from the computation, as the warrants are contingent on achieving specified future sales targets. As of August 31, 2004 and August 31, 2003, we had outstanding warrants and options to purchase common shares of 4,439,915 and 5,509,502, respectively.

### 3. ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	August 31, 2004	November 30, 2003
	-----	-----
Incentive compensation .....	\$178,373	\$166,360
Sales commissions .....	87,370	123,356
Independent sales representative termination ....	80,000	--
Royalty .....	13,635	13,645
Warranty .....	9,150	5,850
Insurance .....	--	29,836
Professional fees .....	--	10,500
	-----	-----
Total .....	\$368,528	\$349,547
	=====	=====

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### SOMANETICS CORPORATION

#### NOTES TO FINANCIAL STATEMENTS (UNAUDITED)

AUGUST 31, 2004

### 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

During fiscal 2004, we have granted the following 10-year stock options to our employees, with the exercise price being equal to the closing sale price of our common shares on the date of grant:

NUMBER OF	EXERCISE	NUMBER OF
-----------	----------	-----------



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DATE ----	OPTIONS -----	PRICE -----	EMPLOYEES -----
12/12/2003	10,000	\$ 6.35	1
1/28/2004	10,000	\$ 9.25	1
3/30/2004	1,500	\$12.00	1
3/31/2004	3,000	\$12.93	1
4/12/2004	1,500	\$13.19	1
8/9/2004	7,500	\$10.70	3
8/16/2004	3,000	\$11.05	1

In addition, on March 30, 2004, we granted 10-year options under the 1997 Stock Option Plan to purchase 14,000 common shares to four of our directors at an exercise price of \$12.00 per share (the closing sale price of the common shares as of the date of grant).

During the nine months ended August 31, 2004, we issued 318,276 common shares as a result of stock option exercises, for proceeds of approximately \$1,526,000.

In March 2004, Kingsbridge Capital Limited purchased 40,000 common shares under its warrants by a cashless exercise. As a result of this cashless exercise, we issued 24,097 common shares to Kingsbridge, retaining 15,903 common shares in payment of the exercise price, and Kingsbridge's warrants entitled it to purchase 65,097 more common shares. In May 2004, Kingsbridge Capital Limited purchased the remaining 65,097 common shares under its warrants by a cashless exercise. As a result of this cashless exercise, we issued 47,475 common shares to Kingsbridge, retaining 17,622 common shares in payment of the exercise price. Kingsbridge now has no warrants remaining to purchase common shares.

In April 2004, CorRestore LLC exercised its warrant to purchase 380,000 of our newly-issued common shares, at \$3.00 per share, for proceeds of \$1,140,000.

In June 2004, Brean Murray & Co., Inc. purchased 100,000 common shares under its warrants by a cashless exercise. As a result of this cashless exercise, we issued 66,265 common shares to Brean Murray & Co., Inc., retaining 33,735 common shares in payment of the exercise price. Brean Murray & Co., Inc. now has no warrants remaining to purchase common shares.

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### SOMANETICS CORPORATION

#### NOTES TO FINANCIAL STATEMENTS (UNAUDITED)

AUGUST 31, 2004

#### 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 95% of our net revenues in the first three quarters of fiscal 2004 were derived from our INVOS Cerebral Oximeter product line, compared to 91% of our net revenues in the first three quarters of fiscal 2003.

SOMANETICS CORPORATION

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

AUGUST 31, 2004

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. In addition, we may make forward-looking statements in future filings with the Securities and Exchange Commission and in written material, press releases and oral statements issued by us or on our behalf. 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 economic conditions in general and in the healthcare market, the demand for and market for our products in domestic and international markets, our history of losses, our current dependence on the Cerebral Oximeter and SomaSensor, the challenges associated with developing new products and obtaining regulatory approvals if necessary, research and development activities, the uncertainty of acceptance of our products by the medical community, the lengthy sales cycle for our products, third party reimbursement, competition in our markets, including the potential introduction of competitive products by others, our dependence on our distributors, physician training, enforceability and the costs of enforcement of our patents, potential infringements of our patents 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 certain risks and uncertainties, that could cause actual results to differ materially from those in such 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 2003 and the first three quarters of fiscal 2004, our primary activities consisted of sales and marketing of the Cerebral Oximeter, the related disposable SomaSensor, and the CorRestore System.

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We derive our revenues from sales of Cerebral Oximeters, SomaSensors and CorRestore Systems to our distributors and to hospitals in the United States through our direct sales employees and independent sales representative firms. We offer to our customers in the United States 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 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.

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### SOMANETICS CORPORATION

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

AUGUST 31, 2004

As described in more detail below, we achieved net income for the quarter and nine months ended August 31, 2004 of approximately \$540,000 and \$1,242,000, or \$0.05 and \$0.11 per diluted common share, respectively. Our net income for the nine months was primarily a result of our 36% increase in net revenues, and a seven percentage point increase in gross margin percentage. Our increase in net revenues was primarily a result of increased unit sales and increased average selling prices for our disposable SomaSensor in the United States. Our increase in gross margin percentage was also primarily attributable to the increase in average selling prices for our disposable SomaSensors, as well as the reduction in the cost of our disposable SomaSensor by approximately 40%, effective May 2004, as a result of changes in our manufacturing process. Our operating expenses increased approximately 17% for the nine month period primarily due to increased commissions paid to our independent sales representative firms and direct sales employees as a result of increased sales, and increased salaries as a result of our hiring additional direct sales personnel in the first nine months of 2004. In the fourth quarter of 2004, we expect to increase expenses associated with the sales and marketing of our products. We had approximately \$1,934,000 of cash provided by operations in the first three quarters of fiscal 2004, and a net increase in cash and cash equivalents of approximately \$4,102,000, primarily as a result of the exercise of stock options and warrants, in addition to our net income. For 2004, we expect to realize a net increase in cash and cash equivalents of approximately \$4,300,000 to \$4,800,000. We project an increase in net revenues for fiscal 2004 of 31% to 37%, with fourth quarter 2004 revenues expected to be in the range of \$3,500,000 to \$4,000,000. We also project net income per diluted common share of \$0.15 to \$0.17 for fiscal 2004.

THREE MONTHS ENDED AUGUST 31, 2004 COMPARED TO THREE MONTHS ENDED AUGUST 31, 2003

Our net revenues increased \$772,493, or 34%, from \$2,303,880 in the three-month period ended August 31, 2003 to \$3,076,373 in the three-month period ended August 31, 2004. The increase in net revenues is attributable to an increase in United States sales of approximately \$792,000, or 44%, from approximately \$1,808,000 in the third quarter of fiscal 2003 to approximately \$2,600,000 in the third quarter of fiscal 2004. This increase is primarily due to an increase in sales of the disposable SomaSensor of approximately \$748,000, or 47%. In addition, we realized an increase in sales of the Cerebral Oximeter of approximately \$35,000, or 32%, and an increase in sales of the CorRestore System of approximately \$9,000, or 8%.

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These increases were partially offset by a decrease in international sales of approximately \$19,000, or 4%, from approximately \$495,000 in the third quarter of fiscal 2003 to approximately \$476,000 in the third quarter of fiscal 2004, primarily due to the timing of purchases by Tyco Healthcare in Europe.

During the quarter, we achieved a 24% increase in the average selling price of SomaSensors in the United States. The increase in the average selling price is attributable to

- the addition of new customers at our higher suggested retail prices, which were effective September 1, 2003,
- increased sales of our small adult SomaSensor that was launched in the third quarter of fiscal 2003,
- increased sales of our pediatric SomaSensor, and
- the upgrade of certain customers to our most recent model Cerebral Oximeter in exchange for the customer agreeing to pay a higher price for the disposable SomaSensor.

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### SOMANETICS CORPORATION

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

AUGUST 31, 2004

In addition, we had a 19% increase in SomaSensor unit sales in the United States to 28,700 units. We expect the average selling price of SomaSensors in the United States will increase by approximately 20% in 2004 compared to 2003, as a result of the factors described above.

We placed 52 Cerebral Oximeters in the United States and 20 internationally in the third quarter of 2004, and our installed base of Cerebral Oximeters in the United States is approximately 700 as of August 31, 2004.

Approximately 15% of our net revenues in the third quarter of fiscal 2004 were from export sales, compared to approximately 21% of our net revenues in the third quarter of fiscal 2003. We expect international net revenues to represent approximately 15% to 20% of total net revenues in 2004.

One international distributor accounted for approximately 10% of our net revenues for the three months ended August 31, 2004, and one international distributor accounted for approximately 17% of our net revenues for the three months ended August 31, 2003.

Sales of our products as a percentage of net revenues were as follows:

PRODUCT -----	PERCENT OF NET REVENUE THIRD QUARTER OF FISCAL	
	2004 ----	2003 ----
SomaSensors.....	85%	73%
Cerebral Oximeters.....	11%	22%
CorRestore Systems.....	4%	5%

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	---	---
Total.....	100%	100%
	===	===

For 2004, we expect sales of SomaSensors to account for 75% to 80% of net revenues, sales of Cerebral Oximeters 15% to 20%, and sales of CorRestore Systems 5%.

Gross margin as a percentage of net revenues was approximately 86% for the quarter ended August 31, 2004 and approximately 77% for the quarter ended August 31, 2003. The increase in gross margin as a percentage of net revenues is attributable to

- a change in the sales mix with increased sales of the disposable SomaSensor, which has a higher gross margin than the Cerebral Oximeter or CorRestore System,
- the increase in the average selling price of SomaSensors described above,
- a reduction in the cost of our SomaSensor by approximately 40%, in May 2004, as a result of changes in our manufacturing process, and
- a change in the sales mix with increased sales in the United States, which have higher gross margins than our international sales to distributors.

We expect gross margins to remain constant in the fourth quarter of fiscal 2004, subject to a potential offset by an increase in international sales, which have lower gross margins than sales in the United States.

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### SOMANETICS CORPORATION

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

AUGUST 31, 2004

Our research, development and engineering expenses increased \$1,566, from \$85,435 for the three months ended August 31, 2003 to \$87,001 for the three months ended August 31, 2004.

Selling, general and administrative expenses increased \$390,806, or 24%, from \$1,628,322 for the three months ended August 31, 2003 to \$2,019,128 for the three months ended August 31, 2004. The increase in selling, general and administrative expense is attributable to

- a \$227,000 increase in salaries, wages, commissions and related expenses, primarily as a result of increased headcount, principally sales and marketing (from an average of 29 employees for the three months ended August 31, 2003 to an average of 34 employees for the three months ended August 31, 2004), and increased sales commissions paid to our sales employees,
- an \$84,000 increase in commissions paid to our independent sales representative firms as a result of increased sales, and

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- a \$72,000 increase in accrued incentive compensation expense as a result of our fiscal 2004 year-to-date financial performance, in accordance with our 2004 Incentive Compensation Plan.

We expect our selling, general and administrative expenses to increase in the fourth quarter primarily as a result of sales personnel added near the end of the third quarter, increased commissions payable to our sales employees and to independent sales representative firms, and increased sales and marketing expenses.

For the three-month period ended August 31, 2004, we realized net income of \$.05 per diluted share, compared to net income of \$.01 in the same period in fiscal 2003. This is primarily attributable to

- a 34% increase in net revenues, and
- a 9% increase in gross margin percentage.

For the three months ended August 31, 2004, we experienced a 23% increase in our operating expenses.

### NINE MONTHS ENDED AUGUST 31, 2004 COMPARED TO NINE MONTHS ENDED AUGUST 31, 2003

Our net revenues increased \$2,321,346, or 36%, from \$6,458,268 in the nine-month period ended August 31, 2003 to \$8,779,614 in the nine-month period ended August 31, 2004. The increase in net revenues is attributable to

- an increase in United States sales of approximately \$2,118,000, or 40%, from approximately \$5,272,000 in the first three quarters of fiscal 2003 to approximately \$7,390,000 in the first three quarters of fiscal 2004. This increase is due to an increase in sales of the disposable SomaSensor of approximately \$2,085,000, or 48%, and an increase in Cerebral Oximeter revenues of approximately \$199,000, or 52%, due to purchases by pediatric hospitals. This increase was partially offset by a decrease in sales of the CorRestore System of approximately \$166,000, or 29%, and
- an increase in international sales of approximately \$203,000, or 17%, from approximately \$1,186,000 in the first three quarters of fiscal 2003 to approximately \$1,389,000 in the first three quarters of fiscal 2004, primarily attributable to increased purchases of the Cerebral Oximeter by Edwards Lifesciences Ltd. in Japan.

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### SOMANETICS CORPORATION

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

AUGUST 31, 2004

During the nine months ended August 31, 2004, we had a 23% increase in the average selling price of SomaSensors in the United States, as described above, and a 20% increase in SomaSensor unit sales in the United States to 80,604 units. We placed 126 Cerebral Oximeters in the United States and 66 internationally in the first nine months of 2004.

Approximately 16% of our net revenues in the first three quarters of

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fiscal 2004 were from export sales, compared to approximately 18% of our net revenues in the first three quarters of fiscal 2003. One international distributor accounted for approximately 13% of net revenues for the nine months ended August 31, 2003.

Sales of our products as a percentage of net revenues were as follows:

PRODUCT -----	PERCENT OF NET REVENUE FIRST THREE QUARTERS OF FISCAL	
	2004 ----	2003 ----
SomaSensors.....	81%	74%
Cerebral Oximeters.....	14%	17%
CorRestore Systems.....	5%	9%
	---	---
Total.....	100%	100%
	===	===

Gross margin as a percentage of net revenues was approximately 83% for the nine months ended August 31, 2004 and approximately 76% for the nine months ended August 31, 2003. 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, and a change in the sales mix with increased sales of the disposable SomaSensor, which have higher gross margins than the Cerebral Oximeter or CorRestore System.

Our research, development and engineering expenses decreased \$58,796, or 18%, from \$328,214 for the nine months ended August 31, 2003 to \$269,418 for the nine months ended August 31, 2004. The decrease is primarily attributable to approximately \$47,000 in decreased costs associated with the development of the CorRestore System, and approximately \$25,000 in decreased costs associated with the Cerebral Oximeter.

Selling, general and administrative expenses increased \$943,399, or 19%, from \$4,867,270 for the nine months ended August 31, 2003 to \$5,810,669 for the nine months ended August 31, 2004. The increase in selling, general and administrative expense is attributable to

- a \$436,000 increase in salaries, wages, commissions and related expenses, primarily as a result of increased headcount, principally sales and marketing (from an average of 29 employees for the nine months ended August 31, 2003 to an average of 32 employees for the nine months ended August 31, 2004), and increased sales commissions paid to our sales employees,
- a \$371,000 increase in commissions paid to our independent sales representatives as a result of increased sales,
- \$96,000 in costs associated with the termination of some of our independent sales representative firms in the second quarter of fiscal 2004,
- a \$72,000 increase in accrued incentive compensation expense as a result of our fiscal 2004 year-to-date financial performance, in accordance with our 2004 Incentive Compensation Plan,

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## SOMANETICS CORPORATION

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

AUGUST 31, 2004

- a \$40,000 increase in clinical research expense, primarily as a result of Dr. Murkin's prospective, randomized study in cardiac surgery, and
- a \$40,000 increase in insurance expense, primarily as a result of a products liability insurance premium refund received in fiscal 2003.

These increases were partially offset by a \$176,000 decrease in customer education expenses for the CorRestore System.

For the nine-month period ended August 31, 2004, we realized net income of \$.11 per diluted share, compared to a net loss of \$.03 per share in fiscal 2003. This is primarily attributable to

- a 36% increase in net revenues, and
- a 7% increase in gross margin percentage.

For the nine months ended August 31, 2004, we experienced a 17% increase in our operating expenses.

#### LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operations during the nine-month period ended August 31, 2004 was approximately \$1,934,000. Cash was provided by

- our net income of approximately \$1,242,000, and depreciation and amortization expense of approximately \$199,000,
- a decrease in inventories of approximately \$313,000, primarily as a result of third quarter 2004 sales and no-cap monitor placements, and our new lower cost SomaSensor which we began shipping in May 2004, and
- a decrease in accounts receivable of approximately \$268,000, primarily because of the timing of sales in the third quarter of 2004 as compared to the fourth quarter of 2003, and more timely collections in the third quarter of fiscal 2004, partially offset by higher sales in the third quarter of 2004 than the fourth quarter of 2003, and
- an increase in accrued liabilities of approximately \$19,000, primarily as a result of an accrual for costs associated with the termination of some of our independent sales representative firms in the second quarter of fiscal 2004 which was paid in September 2004, partially offset by payments made in fiscal 2004 for 2003 accrued sales commissions and insurance.

Cash provided by operations was partially offset by a decrease in accounts payable of approximately \$126,000, primarily as a result of lower inventory levels and more timely payments made to vendors in the first three quarters of fiscal 2004, partially offset by increased operating expenses such as sales



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commissions payable to our independent representative firms.

Capital expenditures in the first nine months of fiscal 2004 were approximately \$498,000. These expenditures were primarily for Cerebral Oximeter demonstration units and no-cap sales units.

During the first three quarters of fiscal 2004, we issued 318,276 common shares as a result of stock option exercises, for proceeds of approximately \$1,526,000.

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### SOMANETICS CORPORATION

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

AUGUST 31, 2004

In March 2004, Kingsbridge Capital Limited purchased 40,000 common shares under its warrants by a cashless exercise. As a result of this cashless exercise, we issued 24,097 common shares to Kingsbridge, retaining 15,903 common shares in payment of the exercise price, and Kingsbridge's warrants entitled it to purchase 65,097 more common shares. In May 2004, Kingsbridge Capital Limited purchased the remaining 65,097 common shares under the warrants by a cashless exercise. As a result of this cashless exercise, we issued 47,475 common shares to Kingsbridge, retaining 17,622 common shares in payment of the exercise price. Kingsbridge now has no warrants remaining to purchase common shares.

In April 2004, CorRestore LLC exercised its warrant to purchase 380,000 of our newly-issued common shares, at \$3.00 per share, for proceeds of \$1,140,000.

In June 2004, Brean Murray & Co., Inc. purchased 100,000 common shares under its warrants by a cashless exercise. As a result of this cashless exercise, we issued 66,265 common shares to Brean Murray & Co., Inc., retaining 33,735 common shares in payment of the exercise price. Brean Murray & Co., Inc. now has no warrants remaining to purchase common shares.

We expect our working capital requirements to increase as sales increase. We expect capital expenditures in 2004 will be approximately \$700,000, primarily for new demonstration and no-cap equipment.

As of August 31, 2004, we had working capital of \$8,090,082, cash and cash equivalents of \$6,341,338, total current liabilities of \$884,014 and shareholder's equity of \$10,073,287. We had an accumulated deficit of \$52,346,526 through August 31, 2004.

We believe that the cash and cash equivalents on hand at August 31, 2004 will be adequate to satisfy our operating and capital requirements for more than the next twelve months. For 2004, we expect to realize positive cash flow from operations, as well as a net increase in cash and cash equivalents, with year-end cash on hand expected to be approximately \$6,500,000 to \$7,000,000.

The estimated length of time current cash and cash equivalents 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 funding requirements necessary to market the Cerebral Oximeter, the disposable SomaSensor, and the CorRestore System, to undertake other product development activities, and for working capital might be substantially greater than current estimates.

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### 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, our accounting treatment of stock options issued to employees, and our revenue recognition associated with our no-cap sales program.

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.

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### SOMANETICS CORPORATION

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

AUGUST 31, 2004

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. It is possible to determine a different life for these licenses, and if they had a definite life, we would amortize the intangible asset over the remaining useful life. However, we believe it is appropriate to use an indefinite life for these licenses.

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

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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 three quarters of fiscal 2004, we granted 50,500 stock options to our employees, and during the first three quarters of fiscal 2003, we granted 471,000 stock options to our employees and directors.

Had we recognized compensation expense for stock options granted to employees in the first three quarters of fiscal 2004, 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 income, on a pro forma basis, would have decreased by approximately \$567,000, or \$.05 per common share. Had we recognized compensation expense for our stock options granted to employees in the first three quarters 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 \$528,000, or \$.06 per common share.

We offer to our customers in the United States 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 SomaSensors. We recognize revenue when we receive purchase orders from the customer for the disposable SomaSensors and ship the disposable SomaSensors to the customer. We do not recognize any revenue upon the initial shipment of the Cerebral Oximeter to the customer at no charge. We believe this is consistent with our stated revenue recognition policy, which is compliant with Staff Accounting Bulletin No. 104 and Emerging Issues Task Force No. 00-21, "Revenue Arrangements with Multiple Deliverables."

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### SOMANETICS CORPORATION

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

AUGUST 31, 2004

#### CONTRACTUAL OBLIGATIONS

The following information is provided as of August 31, 2004 with respect to our known contractual obligations specified in the following table, aggregated by type of contractual obligation:

Contractual Obligations	Total	Payments due by period		
		Less than 1 year	1-3 years	3-5 years
Long-term debt obligations.....	\$ 0	\$ 0	\$ 0	\$
Capital lease obligations.....	\$ 0	\$ 0	\$ 0	\$
Operating lease obligations.....	\$753,900	\$128,700	\$282,600	\$293,0
Purchase obligations.....	\$948,400	\$948,400	\$ 0	\$
Other long-term liabilities.....	\$ 0	\$ 0	\$ 0	\$

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Purchase obligations consist primarily of purchase orders executed for inventory components. During the second quarter of fiscal 2004, we entered into an amendment to our lease agreement, extending the term of the lease through December 31, 2009 and lowering the monthly base rent beginning August 1, 2004.

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### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

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### ITEM 4. CONTROLS AND PROCEDURES

Our management has evaluated, with the participation of our principal executive and principal financial officers, the effectiveness of our disclosure controls and procedures as of August 31, 2004, and, based on their evaluation, our principal executive and principal financial officers have concluded that these controls and procedures are effective as of August 31, 2004. There was no change in our internal control over financial reporting identified in connection with such evaluation that occurred during our third fiscal quarter ended August 31, 2004 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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 or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

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## PART II OTHER INFORMATION

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On June 23, 2004, Brean Murray & Co., Inc. purchased 100,000 of our newly-issued common shares, par value \$0.01 per share, under its warrants by a cashless exercise, at an exercise price of \$5.10 a share. As a result of this cashless exercise, we issued 66,265 common shares to Brean Murray & Co., Inc., retaining 33,735 common shares, valued at approximately \$15.12 a share, in payment of the exercise price. Brean Murray & Co., Inc. now has no warrants remaining to purchase common shares. The common shares were not registered, but were issued in reliance upon the exemptions from registration contained in Sections 4(2) and 4(6) of the Securities Act of 1933.

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### ITEM 6. EXHIBITS

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- 31.1 Certifications of Chief Executive Officer Pursuant to Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certifications of Chief Financial Officer Pursuant to Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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

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(Registrant)

Date: October 7, 2004

By: /s/ William M. Iacona

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

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EXHIBIT INDEX

Exhibit	Description
31.1	Certifications of Chief Executive Officer Pursuant to Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
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32.1	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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