SOMANETICS CORP
Form 10-Q
July 08, 2004

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, 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 July 8, 2004: 10,123,017

PART I FINANCIAL INFORMATION

SOMANETICS CORPORATION

BALANCE SHEETS

	May 31, 2004	November 2003
	(Unaudited)	(Audited
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 5,355,094	$ 2,239,
Accounts receivable	1,730,001	2,018,
Inventory	860,817	1,090,
Prepaid expenses	115,468	123,
Total current assets	8,061,380	5,471,
PROPERTY AND EQUIPMENT (at cost):		
Machinery and equipment	2,316,096	2,071,
Furniture and fixtures	252,971	248,
Leasehold improvements	171,882	171,
Total	2,740,949	2,492,
Less accumulated depreciation and amortization	(1,826,806)	(1,782,
Net property and equipment	914,143	709,
OTHER ASSETS:		
Intangible assets, net	956,382	959,
Other	15,000	15,
Total other assets	971,382	974,
TOTAL ASSETS	$ 9,946,905	$ 7,155,
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 468,846	$ 641,
Accrued liabilities	298,798	349,
Total current liabilities	767,644	990,
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, 10,010,202 shares at May 31, 2004, and 9,298,669 shares at November 30, 2003	100,102	92,
Additional paid-in capital	61,965,407	59,660,
Accumulated deficit	(52,886,248)	(53,588,
Total shareholders' equity	9,179,261	6,165,
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 9,946,905	$ 7,155,

See notes to financial statements

2

SOMANETICS CORPORATION

STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended May 31,		Six M Ended M
	2004	2003	2004
NET REVENUES	$ 3,032,976	$ 2,203,442	$ 5,703,241
COST OF SALES	519,316	561,196	1,039,709
GROSS MARGIN	2,513,660	1,642,246	4,663,532
OPERATING EXPENSES:			
Research, development and engineering	94,727	133,607	182,417
Selling, general and administrative	2,016,641	1,644,016	3,791,541
Total operating expenses	2,111,368	1,777,623	3,973,958
OPERATING INCOME (LOSS)	402,292	(135,377)	689,574
OTHER INCOME:			
Interest income	7,438	6,004	12,901
Total other income	7,438	6,004	12,901
NET INCOME (LOSS)	$ 409,730	$ (129,373)	$ 702,475
NET INCOME (LOSS) PER COMMON SHARE - BASIC	$ 0.04	$ (0.01)	$ 0.07
NET INCOME (LOSS) PER COMMON SHARE - DILUTED	$ 0.04	$ (0.01)	$ 0.06
WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC	9,577,454	9,080,363	9,443,765
WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED	11,588,715	9,080,363	11,264,434

See notes to financial statements

3

SOMANETICS CORPORATION

STATEMENTS OF CASH FLOWS
(UNAUDITED)

	For the Six Month Periods Ended	
	May 31, 2004	May 31, 2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 702,475	$ (324,823
Adjustments to reconcile net income (loss) to net cash provided by (used in) operations:		
Depreciation and amortization	129,135	119,206
Compensation expense for non-employee stock options	-	2,492
Changes in assets and liabilities:		
Accounts receivable (increase) decrease	288,614	(26,476
Inventory (increase) decrease	229,444	(131,072
Prepaid expenses (increase) decrease	7,735	(30,566
Accounts payable increase (decrease)	(172,386)	100,318
Accrued liabilities (decrease)	(50,749)	(11,259
Net cash provided by (used in) operations	1,134,268	(302,180
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property and equipment (net)	(330,085)	(187,718
Net cash (used in) investing activities	(330,085)	(187,718
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common shares due to exercise of stock options and warrants	2,311,719	3,600
Net cash provided by financing activities	2,311,719	3,600
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,115,902	(486,298
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	2,239,192	2,381,808
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 5,355,094	$ 1,895,510
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, 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 six-month period ended May 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:

	May 31, 2004	November 30, 2003
Finished goods	$472,985	$ 354,024
Work in process	57,179	173,193
Purchased components..	330,653	563,044
Total	$860,817	$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 two quarters of fiscal 2004, we capitalized approximately $265,000 in costs for Cerebral Oximeters being used as demonstration and no-cap units, and during the first two quarters of fiscal 2003 we capitalized approximately $148,000 in costs for Cerebral Oximeters being used as demonstration and no-cap 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 is as follows:

	May 31, 2004	November 30, 2003
Patents and trademarks	111,733	111,733
Less accumulated amortization	(84,444)	(80,988)
Total	$ 27,289	$ 30,745

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

MAY 31, 2004

Amortization expense for the six months ended May 31, 2004 and May 31, 2003 was approximately $3,500. 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:

	May 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 two quarters of fiscal 2004, we granted 40,000 stock options to our employees and directors, and we issued 259,961 newly-issued common shares as a result of stock option exercises. During the first two quarters of fiscal 2003, we granted 39,000 stock options to our employees and directors, and we issued 2,500 newly-issued common shares as a result of stock option exercises.

	FOR THE THREE MONTHS ENDED	FOR THE SIX MONTHS EN

	MAY 31, 2004	MAY 31, 2003	MAY 31, 2004	MAY 31,
Net income (loss)	$ 409,730	$(129,373)	$ 702,475	$(324,
Add: Stock-based employee compensation included in actual net income (loss)	$ 0	$ 521	$ 0	$ 2,
Deduct: Total stock-based employee compensation expense, had fair value method been applied..	$(191,183)	$(146,435)	$(369,392)	$(291,
Pro-forma net income (loss)	$ 218,547	$(275,287)	$ 333,083	$(614,
Net income (loss) per common share - diluted	$ .04	$ (.01)	$ .06	$ (
Pro forma net income (loss) per common share - diluted	$ .02	$ (.03)	$ .03	$ (

6

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

MAY 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 six months ended May 31, 2004, includes the potential dilution that could occur for common stock issuable under stock options or warrants. For the three and six months ended May 31, 2004, the difference between weighted average shares - diluted and weighted average shares - basic is calculated as follows:

	Three Months	Six Months
Weighted average shares - basic	9,557,454	9,443,765
Add: effect of dilutive common shares and warrant	2,011,261	1,820,669
Weighted average shares - diluted	11,588,715	11,264,434

Common shares issuable under stock options and warrants have not been included in the computation of net loss per common share - diluted for the three and six months ended May 31, 2003, because such inclusion would be antidilutive. For the three and six months ended May 31, 2004, there were approximately 1,500 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, and there were approximately 1,633,000 warrants outstanding that were excluded from the computation, as the warrants are contingent on achieving specified future sales targets. As of May 31, 2004 and May 31, 2003, we had outstanding warrants and options to purchase common shares of 4,590,794 and 5,186,833, respectively.

3. ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	May 31, 2004	November 30, 2003
Incentive compensation	$ 95,108	$166,360
Independent sales representative termination	80,000	-
Sales commissions	68,786	123,356
Insurance	36,050	29,836
Royalty	11,254	13,645
Warranty	7,600	5,850
Professional fees	-	10,500
Total	$298,798	$349,547

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 December 12, 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 $6.35 per share (the closing sale price of the common shares as of the date of grant). Effective January 28, 2004, 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 $9.25 per share (the closing sale price of the common shares as of the date of grant). Effective March 30, 2004, we granted 10-year options under the 1997 Stock Option Plan to purchase 15,500 common shares to four of our directors and one of our employees at an exercise price of $12.00 per share (the closing sale price of the common shares as of the date of grant). Effective March 31, 2004, we granted 10-year options under the 1997 Stock Option Plan to purchase 3,000 common shares to one of our employees at an exercise price of $12.93 per share (the closing sale price of the common shares as of the date of grant). Effective April 12, 2004, we granted 10-year options under the 1997 Stock Option Plan to purchase 1,500 common shares to one of our employees at an exercise price of $13.19 per share (the closing sale price of the common shares as of the date of grant).

During the six months ended May 31, 2004, we issued 259,961 common shares as a result of stock option exercises, for proceeds of approximately $1,172,000.

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.

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 94% of our net revenues in the first two quarters of fiscal 2004 were derived from our INVOS Cerebral Oximeter product line, compared to 89% of our net revenues in the first two quarters of fiscal 2003.

SOMANETICS CORPORATION

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

MAY 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 two quarters of fiscal 2004, 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, 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.

As described in more detail below, we achieved net income for the quarter and six months ended May 31, 2004 of approximately $410,000 and $702,000, or $0.04 and $0.06 per diluted common share, respectively. Our net income for the six months was primarily a result of our 37% increase in net revenues, and a six 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, and our increase in gross margin percentage was also primarily attributable to the increase in average selling prices for our disposable SomaSensors. In May 2004, we reduced the cost of our disposable SomaSensor by approximately 40% as a result of changes in our manufacturing process. We expect this to have a positive impact on gross margins in the second half of 2004. Our operating expenses increased approximately 19% for the six months primarily due to increased commissions paid to our independent sales representative firms and direct sales employees as a result of increased sales. In the second half of 2004, we expect to hire additional direct sales personnel and also to increase expenses associated with the sales and marketing of our products. We had approximately $1,134,000 of cash provided by operations in the first two quarters of fiscal 2004, and a net increase in cash and cash equivalents of approximately $3,116,000, 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 $4,000,000 to $4,500,000. We project an increase in net revenues for fiscal 2004 of 30% to 40%. We also project net income per basic common share of $0.15 to $0.18, and net income per diluted common share of $0.13 to $0.15 for fiscal 2004.

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

Our net revenues increased $829,534, or 38%, from $2,203,442 in the three-month period ended May 31, 2003 to $3,032,976 in the three-month period ended May 31, 2004. The increase in net revenues is attributable to

- an increase in United States sales of approximately $694,000, or 38%, from approximately $1,812,000 in the second quarter of fiscal 2003 to approximately $2,506,000 in the second quarter of fiscal 2004. This increase is primarily due to an increase in sales of the disposable SomaSensor of approximately $816,000, or 58%, partially offset by a decrease in sales of the CorRestore System of approximately $120,000, or 52%, and

- an increase in international sales of approximately $135,000, or 35%, from approximately $391,000 in the second quarter of fiscal 2003 to approximately $526,000 in the second quarter of fiscal 2004, primarily attributable to increased purchases of the Cerebral Oximeter by Edwards Lifesciences Ltd. in Japan.

During the quarter, we had a 23% 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.

In addition, we had a 29% increase in SomaSensor unit sales in the United States to 27,684 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 44 Cerebral Oximeters in the United States and 29 internationally in the second quarter of 2004, and our installed base of

Cerebral Oximeters in the United States is 644 as of May 31, 2004.

Approximately 17% of our net revenues in the second quarter of fiscal 2004 were from export sales, compared to approximately 18% of our net revenues in the second quarter of fiscal 2003. We expect international net revenues to represent approximately 20% of total net revenues in 2004.

One international distributor accounted for approximately 10% of our net revenues for the three months ended May 31, 2004, and one international distributor accounted for approximately 15% of our net revenues for the three months ended May 31, 2003.

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

	PERCENT OF NET REVENUE SECOND QUARTER OF FISCAL	
PRODUCT	2004	2003
SomaSensors	81%	72%
Cerebral Oximeters	15%	17%
CorRestore Systems	4%	11%
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% to 10%.

Gross margin as a percentage of net revenues was approximately 83% for the quarter ended May 31, 2004 and approximately 75% for the quarter ended May 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, and

- a reduction in the cost of our SomaSensor by approximately 40%, in May 2004, as a result of changes in our manufacturing process.

We expect gross margins to continue to increase in the second half of fiscal 2004, primarily as a result of the reduced manufacturing cost of the disposable SomaSensor. The expected increase in gross margins will be partially offset by our expected increase in international sales, which have lower gross margins than sales in the United States.

MAY 31, 2004

Our research, development and engineering expenses decreased $38,880, or 29%, from $133,607 for the three months ended May 31, 2003 to $94,727 for the three months ended May 31, 2004. The decrease is attributable to approximately $41,000 in decreased development costs associated with the CorRestore System.

Selling, general and administrative expenses increased $372,625, or 23%, from $1,644,016 for the three months ended May 31, 2003 to $2,016,641 for the three months ended May 31, 2004. The increase in selling, general and administrative expense is attributable to

- a $163,000 increase in salaries, wages, commissions and related expenses, primarily as a result of increased sales commissions paid to our sales employees and increased payroll taxes associated with the exercise of stock options, and

- a $130,000 increase in commissions paid to our independent sales representative firms as a result of increased sales,

- approximately $96,000 in costs associated with the termination of some of our independent sales representative firms in the second quarter of fiscal 2004, and

- a $40,000 increase in clinical research expense, primarily as a result of Dr. Murkin's prospective, randomized study in cardiac surgery.

These increases were partially offset by a $55,000 decrease in customer education expenses for the CorRestore System. We expect our selling, general and administrative expenses to increase primarily as a result of sales personnel added near the end of the second quarter, hiring additional direct sales personnel in the second half of 2004 and increased commissions payable to our sales employees and to independent sales representative firms.

For the three-month period ended May 31, 2004, we realized net income of $.04 per share, compared to a loss per share of $.01 in the same period in fiscal 2003. This is primarily attributable to

- a 38% increase in net revenues, and

- an 8% increase in gross margin percentage.

For the three months ended May 31, 2004, we experienced a 19% increase in our operating expenses.

SIX MONTHS ENDED MAY 31, 2004 COMPARED TO SIX MONTHS ENDED MAY 31, 2003

Our net revenues increased $1,548,853, or 37%, from $4,154,388 in the six-month period ended May 31, 2003 to $5,703,241 in the six-month period ended May 31, 2004. The increase in net revenues is attributable to

- an increase in United States sales of approximately $1,326,000, or 38%, from approximately $3,464,000 in the first two quarters of fiscal 2003 to approximately $4,790,000 in the first two quarters of fiscal 2004. This increase is due to an increase in sales of the disposable SomaSensor of approximately $1,337,000, or 49%, and an increase in Cerebral Oximeter revenues of approximately $164,000, or 60%, due to purchases by pediatric hospitals. This increase was partially offset by a decrease in sales of the CorRestore System of approximately $175,000, or 39%, and

- an increase in international sales of approximately $223,000, or 32%, from approximately $690,000 in the first two quarters of fiscal 2003 to approximately $913,000 in the first two quarters of fiscal 2004, primarily attributable to increased purchases of the Cerebral Oximeter by Edwards Lifesciences Ltd. in Japan.

12

SOMANETICS CORPORATION

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

MAY 31, 2004

During the six months ended May 31, 2004, we had a 23% increase in the average selling price of SomaSensors in the United States, as described above, and a 21% increase in SomaSensor unit sales in the United States to 51,904 units. We placed 74 Cerebral Oximeters in the United States and 46 internationally in the first six months of 2004.

Approximately 16% of our net revenues in the first two quarters of fiscal 2004 were from export sales, compared to approximately 17% of our net revenues in the first two quarters of fiscal 2003. One international distributor accounted for approximately 11% of net revenues for the six months ended May 31, 2003.

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

	PERCENT OF NET REVENUE FIRST TWO QUARTERS OF FISCAL	
PRODUCT	2004	2003
SomaSensors	79%	74%
Cerebral Oximeters	15%	15%
CorRestore Systems	6%	11%
Total	100%	100%

Gross margin as a percentage of net revenues was approximately 82% for the six months ended May 31, 2004 and approximately 76% for the six months ended May 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 $60,362, or 25%, from $242,779 for the six months ended May 31, 2003 to $182,417 for the six months ended May 31, 2004. The decrease is primarily attributable to approximately $47,000 in decreased costs associated with the development of the CorRestore System.

Selling, general and administrative expenses increased $552,593, or 17%, from $3,238,948 for the six months ended May 31, 2003 to $3,791,541 for the six months ended May 31, 2004. The increase in selling, general and administrative expense is attributable to

- a $287,000 increase in commissions paid to our independent sales representatives as a result of increased sales,

- a $209,000 increase in salaries, wages, commissions and related expenses, primarily as a result of increased sales commissions paid to our sales employees and increased payroll taxes associated with the exercise of stock options,

- approximately $96,000 in costs associated with the termination of some of our independent sales representative firms in the second quarter of fiscal 2004, and

- a $57,000 increase in clinical research expense, primarily as a result of Dr. Murkin's prospective, randomized study in cardiac surgery.

These increases were partially offset by a $152,000 decrease in customer education expenses for the CorRestore System.

13

SOMANETICS CORPORATION

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

MAY 31, 2004

For the six-month period ended May 31, 2004, we realized net income of $.06 per diluted share, compared to a net loss of $.04 per share in fiscal 2003. This is primarily attributable to

- a 37% increase in net revenues, and

- a 6% increase in gross margin percentage.

For the six months ended May 31, 2004, we experienced a 14% increase in our operating expenses.

LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operations during the six-month period ended May 31, 2004 was approximately $1,134,000. Cash was provided by

- our net income of approximately $702,000, after depreciation and amortization expense of approximately $129,000,

- a decrease in accounts receivable of approximately $289,000, primarily because of the timing of sales in the second quarter of 2004 as compared to the fourth quarter of 2003, and more timely collections in the second quarter of fiscal 2004, partially offset by higher sales in the second quarter of 2004 than the fourth quarter of 2003, and

- a decrease in inventories of approximately $229,000, primarily as a result of second quarter 2004 sales, and our new lower cost SomaSensor which we began shipping in May 2004.

Cash provided by operations was partially offset by

- a decrease in accounts payable of approximately $172,000, primarily as a result of lower inventory levels and more timely payments made to vendors in the first two quarters of fiscal 2004, partially offset by increased sales commissions payable to our independent representative firms, and

- a decrease in accrued liabilities of approximately $51,000, primarily as a result of payments made in fiscal 2004 for 2003 accrued bonuses and sales commissions, partially offset by an accrual for costs associated with the termination of some of our independent sales representative firms in the second quarter of fiscal 2004.

Capital expenditures in the first six months of fiscal 2004 were approximately $330,000. These expenditures were primarily for Cerebral Oximeter demonstration units and no-cap sales units.

During the first two quarters of fiscal 2004, we issued 259,961 common shares as a result of stock option exercises, for proceeds of approximately $1,172,000.

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 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.

We expect our working capital requirements to increase as sales increase. We expect capital expenditures in 2004 will be approximately $600,000, primarily for new demonstration and no-cap equipment.

As of May 31, 2004, we had working capital of $7,293,736, cash and cash equivalents of $5,355,094, total current liabilities of $767,644 and shareholder's equity of $9,179,261. We had an accumulated deficit of $52,886,248 through May 31, 2004.

We believe that the cash and cash equivalents on hand at May 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 in the range of $6.0 million to $6.5

million.

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.

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.

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 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 2004, we granted 40,000 stock options to our employees, and during the first two quarters of fiscal 2003, we granted 39,000 stock options to our employees.

Had we recognized compensation expense for stock options granted to employees in the first two 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 $369,000, or $.03 per common share. Had we recognized compensation expense for our stock options granted to employees in the first two 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 $289,000, or $.03 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 Bulleting No. 104 and Emerging Issues Task Force No. 00-21, "Revenue Arrangements with Multiple Deliverables."

CONTRACTUAL OBLIGATIONS

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

Payments due by period

Contractual Obligations	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt obligations	$ 0	$ 0	$ 0	$ 0	$ 0
Capital lease obligations	$ 0	$ 0	$ 0	$ 0	$ 0
Operating lease obligations	$811,000	$150,600	$281,900	$291,600	$86,900
Purchase obligations	$734,500	$734,500	$ 0	$ 0	$ 0
Other long-term liabilities	$ 0	$ 0	$ 0	$ 0	$ 0

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.

17

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

18

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 May 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 May 31, 2004. There was no change in our internal control over financial reporting identified in connection with such evaluation that occurred during our second fiscal quarter ended May 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.

19

PART II OTHER INFORMATION

ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

On March 19, 2004, Kingsbridge Capital Limited purchased 40,000 of our newly-issued common shares, par value $0.01 per share, under its warrants by a cashless exercise, at an exercise price of $4.25 a share. As a result of this cashless exercise, we issued 24,097 common shares to Kingsbridge, retaining

15,903 common shares, valued at approximately $10.69 a share, in payment of the exercise price, and Kingsbridge's warrants entitled it to purchase 65,097 more common shares. On May 26, 2004, Kingsbridge Capital Limited purchased the remaining 65,097 of our newly-issued 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, valued at approximately $15.70 a share, in payment of the exercise price. Kingsbridge 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.

On April 27, 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. 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.

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

Our Annual Meeting of Shareholders was held on March 31, 2004. At the Annual Meeting, Bruce J. Barrett was elected as a director and the terms of office of Dr. James I. Ausman, Daniel S. Follis, Robert R. Henry and Joe B. Wolfe as directors continued after the meeting. 8,174,497 votes were cast for Mr. Barrett's election and 29,847 votes were withheld from Mr. Barrett's election. There were no abstentions or broker non-votes in connection with the election of the directors at the Annual Meeting.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

10.1 Sixth Amendment, between Somanetics Corporation and First Industrial Mortgage Partnership, L.P., dated April 21, 2004.

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.

(b) Reports on Form 8-K

We filed a Current Report on Form 8-K on April 27, 2004, reporting under Item 5 that on April 27, 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. No financial statements were filed.

In addition, we furnished a Current Report on Form 8-K on March 16, 2004, reporting under Item 12 that on March 16, 2004, we announced our financial results for our first quarter ended February 29, 2004 and certain other information. No financial statements were filed, although we furnished the financial information included in the press release furnished with the Form 8-K.

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 8, 2004

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

EXHIBIT INDEX

Exhibit	Description
10.1	Sixth Amendment, between Somanetics Corporation and First Industrial Mortgage Partnership, L.P., dated April 21, 2004.
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.