

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

**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2003

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-16752

**MEDSTONE INTERNATIONAL, INC.**

(Exact name of registrant as specified in its charter)

DELAWARE

66-0439440

(State or other jurisdiction of incorporation or organization)

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

100 Columbia, Suite 100, Aliso Viejo, California

92656

(Address of principal executive offices)

(Zip code)

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

Not Applicable

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

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

YesNo

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

YesNo

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

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

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

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

See accompanying notes

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

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

See accompanying notes.

**MEDSTONE INTERNATIONAL, INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

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

See accompanying notes.

## MEDSTONE INTERNATIONAL, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Six months ended June 30, 2003 and 2002

(Unaudited)

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

See accompanying notes.

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

**A. Basis of presentation**

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

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

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

**B. Accumulated Other Comprehensive Loss:**

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

|  | <b>Currency<br/>Translation<br/>Adjustment</b> |
|--|--|
| Balance at December 31, 2002             | \$ (22,054)                                    |
| Foreign currency translation adjustments | 16,701   |
| <b>Balance at June 30, 2003</b>          | <b>\$ (5,353)</b>                              |

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

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



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

**C. Business Segments**

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

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

**D. Per share information**

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

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

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

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

**E. Inventories**

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

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

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

**F. Contingencies**

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

**G. Stock Compensation**

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

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

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

|                                  | Three Months ended |               | Six Months ended |               |
|----------------------------------|--------------------|---------------|------------------|---------------|
|                                  | June 30, 2003      | June 30, 2002 | June 30, 2003    | June 30, 2002 |
| <b>Net income (loss):</b>        |                    |               |                  |               |
| As reported                      | \$ (62)            | \$ 81         | \$ (184)         | \$ 248        |
| Compensation expense, net of tax | 32                 | 55            | 74               | 110           |
| <b>Pro forma</b>                 | <b>\$ (94)</b>     | <b>\$ 26</b>  | <b>\$ (258)</b>  | <b>\$ 138</b> |
| <b>Earnings per share:</b>       |                    |               |                  |               |
| Basic                            | \$ (.02)           | \$ .02        | \$ (.05)         | \$ .06        |
| Diluted                          | N/A                | \$ .02        | N/A              | \$ .06        |
| Pro forma basic                  | \$ (.03)           | \$ .01        | \$ (.07)         | \$ .04        |
| Pro forma diluted                | N/A                | \$ .01        | N/A              | \$ .04        |

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The following discussion and analysis should be read in conjunction with the Company's audited financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's 2002 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 31, 2003.

In the ordinary course of business, the company has made a number of estimates and assumptions relating to the reporting of results of operations and financial condition in the preparation of its financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ significantly from those estimates under different assumptions and conditions. The Company believes that the following discussion addresses the Company's most critical accounting policies, which are those that are most important to the portrayal of the Company's financial condition and results. The Company constantly re-evaluates these significant factors and makes adjustments where facts and circumstances dictate. Historically, actual results have not significantly deviated from those determined using the necessary estimates inherent in the preparation of financial statements. Estimates and assumptions include, but are not limited to, customer receivables, inventories, equity investments, fixed asset lives, contingencies and litigation. The Company has also chosen certain accounting policies when options were available, including:

- The average cost method to value a majority of our inventories; and
- The intrinsic value method, or APB Opinion No. 25, to account for our common stock incentive awards; and
- We record an allowance for credit losses based on estimates of customers' ability to pay. If the financial condition of our customers were to deteriorate, additional allowances may be required.

These accounting policies are applied consistently for all periods presented. Our operating results would be affected if other alternatives were used. Information about the impact on our operating results is included in the footnotes to our consolidated financial statements.

**Results of Consolidated Operations**

**General**

Medstone manufactures, markets and maintains lithotripters, and utilizes its Fee-for-Service Program to supply lithotripsy equipment to providers on a per procedure basis. The lithotripters manufactured by Medstone is approved to treat both kidney stones and gallstones. The Company is also marketing a urology imaging and treatment table, used for various urological functions, mobile urology and pain management table to serve the mobile treatment market and various radiology room equipment, capitalizing on the relationships that the Company has with radiology equipment manufacturers. To date, the Company's consolidated revenues have come primarily from Medstone's

lithotripsy business.

As a manufacturer of medical devices, the Company is vertically integrated by offering its medical devices directly to providers. It currently offers lithotripsy procedures using 14 mobile systems, one fixed site and 23 transmobile lithotripters located throughout the United States on a per procedure basis. With the ability to offer state-of-the-art equipment at reasonable prices, Medstone continues to consider this part of its business as an integral part of its business plan.

Three Months ended June 30, 2003 Compared to Three Months Ended June 30, 2002

The Company recognized total revenue of \$5.5 million in the second quarter of 2003 compared to \$6.0 million in the second quarter of 2002, or an 8% decrease. Revenues from procedures, maintenance and management fees decreased from \$4.3 million in the three months ended June 30, 2002 to \$4.0 million in the three months ended June 30, 2003 due to both lower average per patient charges on the Company's fee-for-service equipment and lower third party patient count. Also decreasing were maintenance revenues as there a number of sites that discontinued maintenance contracts as a cost cutting measure. Equipment revenues decreased slightly to \$1.47 million in the quarter ending June 30, 2003 from \$ 1.64 million in the comparable quarter of the prior year, or a 10% decrease. The Company shipped two lithotripsy systems, one urology table and 35 various patient handling tables shipped in the 3 months ended June 30, 2003 compared to three lithotripsy systems, one urology system and 26 various patient handling tables shipped in the same period of 2002.

Interest income decreased by 52% in the second quarter of 2003 when compared to the same period of the prior year due to a significant decline in investment yields and a significant decline in the average invested balance.

Recurring revenue cost of sales increased to 64% of sales in the quarter ended June 30, 2003 compared to 61% in the same quarter of the prior year. This is due to lower revenue per patient in this segment with no significant decrease in the costs of providing service. Cost of sales on equipment sales decreased to 70% of sales in the three months ended June 30, 2003 compared to 73% of sales in the same period of 2002. This decrease is due to a slight decrease in costs and slightly higher average sales price per unit on the patient handling tables. Overall cost of sales, as a percentage of revenue (excluding interest), increased to 65% in the second quarter of 2003 compared to 64% in the second quarter of 2002.

Research and development costs increased to \$496,000 in the second quarter of 2003 compared to \$314,000 in the second quarter of 2002 or an increase of 58% due to consulting expenses and material costs associated with the development of the UroPro Vista next generation urology table and the MultiRad imaging system. The Company expects to complete both projects by the 4<sup>th</sup> quarter of 2003.

General and administrative expenses decreased by \$103,000 or 12% in the three months ended June 30, 2003 compared to the same period in the prior year due to the prior years consulting and legal expenses involved in exploring acquisitions.

Total minority interest expense decreased to \$24,000 in the three months ended June 30, 2003 compared to \$161,000 in the same period of the prior year due to recognition of operating profits at Arcoma AB in the current quarter compared to no profit or loss in 2002. The Company's expense for minority distributions in the Northern Nevada and Southern Idaho operations remained almost unchanged in both periods.

Six Months Ended June 30, 2003 Compared to Six Months Ended June 30, 2002

The Company recorded total revenue of \$10.3 million in the first six months of 2003 or a 16% decrease compared to \$12.3 million in the corresponding period of 2002. Revenues from procedures, maintenance and management fees decreased by \$582,000, or 7%, due to lower average reimbursement per patient and lower overall patient count, which decreased by 6% in the current year. Equipment revenue decreased by \$1,346,000, or 38%, as unit shipments of lithotripsy units and urology tables decreased in 2003 when compared to 2002. Two lithotripsy systems were shipped in the current year compared to six units in the prior year. Two urology systems were shipped in the six months ended June 30, 2003 compared to four units in the six months ended June 30, 2002. Offsetting some of the decrease in unit shipments is an increase in the shipment of the Company's imaging tables, as the Company has shipped 66 various types of tables in 2003 compared to 42 units sold in the corresponding period of 2002.

Interest income decreased by 52% for the first six months of 2003 when compared to the same period of the prior year as significantly lower interest yields were earned on lower average invested balances.

Procedure, maintenance and management fee cost of sales increased to 59% in the six months ended June 30, 2003 compared to 58% in the same period of the prior year as revenue decreased with no appreciable change in the cost of provision of service. Cost of sales on equipment sales increased to 84% of revenue in the first six months of 2003 compared to 75% of revenue in the first six months of 2002 due to a lower number of lithotripsy units sold, which have higher profit margins compared to imaging tables. Overall cost of sales, as a percentage of revenue (excluding interest), increased slightly to 64% in the first six months of 2003 compared to 63% in the same period of 2002.

Research and development costs increased by \$330,000, or 57% in the first six months of 2003 when compared to the same period of 2002 as the Company has undertaken major development work for the UroPro Vista urology table and MultiRad imaging system.

Selling costs decreased by 13%, or \$203,000, in the first six months of 2003 compared to the same period of 2002 due to lower commission expense on lower revenues and 2002's services related to the gallstone marketing efforts.

General and administrative expenses decreased by 7%, or \$118,000, in the six months ended June 30, 2003 compared to the first six months of 2002 due to the prior years consulting and legal expenses.

Total minority interest expense decreased to \$125,000 in the six months ended June 30, 2003 compared to \$361,000 in the same period of the prior year due to recognition of \$225,000 in operating profits in the current year compared to \$30,000 of operating losses in 2002 for the Company's 25% equity interest in Arcoma AB. The Company's expense for minority distributions in the Northern Nevada and Southern Idaho operations increased by \$19,000 in the six months ended June 30, 2003 when compared to the six months ended June 30, 2002.

Provision for (benefit from) income taxes decreased to a benefit of \$70,000 in the first six months of 2003 compared tax expense of \$196,000 for the same period of 2002 as a result of operating losses in the current year compared to taxable operating profits in the prior year.

#### Liquidity and Capital Resources

At June 30, 2003, the Company had cash and short-term investments of approximately \$6.1 million. These funds were generated from continuing operating activities.

As of June 30, 2003, the Company held 13,571 shares of CorAutus Genetics, Inc. common stock, with an approximate market value of \$18,864. The Company will continue to liquidate its holdings in this Company as markets allow.

The Company's long-term capital expenditure requirements will depend on numerous factors, including the progress of the Company's research and development programs, the time required to obtain regulatory approvals, the resources that the Company devotes to the development of self-funded products, proprietary manufacturing methods and advanced technologies, the costs of acquisitions and/or new revenue opportunities, the ability of the Company to obtain additional licensing arrangements and to manufacture products under those arrangements, and the demand for its products if and when approved and possible acquisitions of products, technologies and companies.

The Company believes that its existing working capital and funds anticipated to be generated from operations will be sufficient to meet the cash needs for continuation of its present operations during 2003.

#### **Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995**

Forward-looking statements in this report, including without limitation, statements relating to the Company's plans, strategies, objectives, expectations, intentions and adequacy of resources, are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Investors are cautioned that such forward-looking statements involve risks and uncertainties including

without limitation the following: (i) the Company's plans, strategies, objections, expectations and intentions are subject to change at any time at the discretion of the Company, (ii) the Company's plans and results of operations will be affected by the Company's ability to manage its growth; (iii) the Company's businesses are highly competitive and the entrance of new competitors into or the expansion of the operations by existing competitors in the Company's markets and other changes could adversely affect the Company's plans and results of operations; and (iv) other risks and uncertainties indicated from time to time in the Company's filings with the Securities and Exchange Commission.

**Item 3. Market Risk Changes**

The Company has no significant market risk changes for the period ended June 30, 2003.

**Item 4. Controls and Procedures**

Within the 90-day period prior to the date of this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 15d-14 (c). ] Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in a timely manner to alert them to material information relating to the Company which is required to be included in the Company's periodic Securities and Exchange Commission filings. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the evaluation date.



**MEDSTONE INTERNATIONAL, INC.**  
**PART II. OTHER INFORMATION**

Item 1. Legal Proceedings

Previously reported.

Item 2. Changes in Securities

None

Item 3. Defaults upon Senior Securities

None

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

(a) The annual meeting of stockholders of the Company was held on July 24, 2003.

(b) The election of four board of directors of the Company was held. The number of shares cast for each of the individuals listed below to serve until the next Annual Meeting of stockholders and until their successors are elected and have qualified was as follows:

| Name                | For       | Withheld |
|---------------------|-----------|----------|
| David V. Radlinski  | 3,246,536 | 442,777  |
| Frank R. Pope       | 3,251,565 | 437,748  |
| Jack Olshansky      | 3,234,684 | 454,629  |
| David A. Reed       | 3,269,384 | 419,929  |
| Michael C. Tibbitts | 3,253,065 | 436,248  |

(c) The ratification of the appointment of Moss Adams LLP as independent accountants of the Company for the year ending December 31, 2003.

|         |           |
|---------|-----------|
| For     | 3,511,375 |
| Against | 164,438   |
| Abstain | 13,500    |

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a) The following exhibits are included herein:

- 10.30 Amendment No. 1 to Employment Agreement with David Radlinski
- 10.31 Amendment No. 1 to Employment Agreement with Mark Selawski
- 10.32 Amendment No. 1 to Employment Agreement with Eva Novotny
- 31.1 Certificate of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 dated August 1, 2003.
- 31.2 Certificate of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 dated August 1, 2003.
- 32 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to section 18 U.S.C. section 1350 dated August 1, 2003.

(b) Reports on Form 8-K.

On May 12, 2003, we filed a Current Report on Form 8-K with the Securities and Exchange Commission, reporting under *Item 9. Regulation FD Disclosure* (furnished under *Item 12. Results of Operations and Financial Condition*) our operating results for the quarter ended March 31, 2003.

**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 hereunto duly authorized.

Date: August 13, 2003

**MEDSTONE INTERNATIONAL, INC.**

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A Delaware corporation

/s/ MARK SELAWSKI

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**Mark Selawski**  
**Chief Financial Officer**  
**(Principal financial and accounting officer)**

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**Exhibit Index**

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