SOMANETICS CORP
Form 10-Q
April 11, 2005

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 FEBRUARY 28, 2005

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 April 11, 2005: 10,175,782

PART I FINANCIAL INFORMATION

SOMANETICS CORPORATION

BALANCE SHEETS

	February 28, 2005 (Unaudited)
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	$ 7,502,506
Accounts receivable	2,312,049
Inventory	663,979
Prepaid expenses	183,794
Deferred tax asset - current	575,184
Total current assets	11,237,512
PROPERTY AND EQUIPMENT (at cost):	
Demonstration and no-cap sales equipment at customers	1,690,020
Machinery and equipment	712,007
Furniture and fixtures	255,044
Leasehold improvements	171,882
Total	2,828,953
Less accumulated depreciation and amortization	(1,686,808)
Net property and equipment	1,142,145
OTHER ASSETS:	
Deferred tax asset - non-current	5,834,309
Intangible assets, net	951,198
Other	15,000
Total other assets	6,800,507
TOTAL ASSETS	$ 19,180,164
LIABILITIES AND SHAREHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Accounts payable	$ 697,396
Accrued liabilities	303,204
Total current liabilities	1,000,600
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, 10,147,282 shares at February 28, 2005, and 10,137,782 shares at November 30, 2004	101,473
Additional paid-in capital	62,396,312
Accumulated deficit	(44,318,221)
Total shareholders' equity	18,179,564
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 19,180,164

See notes to financial statements

SOMANETICS CORPORATION

STATEMENTS OF OPERATIONS
(UNAUDITED)

	For the Three-Month Periods Ended	
	February 28, 2005	February 29, 2004
NET REVENUES	$ 4,032,617	$ 2,670,265
COST OF SALES	550,149	520,393
GROSS MARGIN	3,482,468	2,149,872
OPERATING EXPENSES:		
Research, development and engineering	95,802	87,690
Selling, general and administrative	2,576,136	1,774,900
Total operating expenses	2,671,938	1,862,590
OPERATING INCOME	810,530	287,282
OTHER INCOME:		
Interest income	43,903	5,462
Total other income	43,903	5,462
NET INCOME BEFORE INCOME TAXES	854,433	292,744
INCOME TAX PROVISION	(290,507)	--
NET INCOME	$ 563,926	$ 292,744
NET INCOME PER COMMON SHARE - BASIC	$ .06	$ .03
NET INCOME PER COMMON SHARE - DILUTED	$ .05	$ .03
WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC	10,140,015	9,308,607
WEIGHTED AVERAGE SHARES		

OUTSTANDING - DILUTED	11,840,093	11,296,295

See notes to financial statements

SOMANETICS CORPORATION

STATEMENTS OF CASH FLOWS
(UNAUDITED)

	For the Perio
	February 28, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income	$ 563,926
Adjustments to reconcile net income to net cash provided by operations:	
Income tax provision	290,507
Depreciation and amortization	82,563
Changes in assets and liabilities:	
Accounts receivable (increase) decrease	(289,505)
Inventory (increase)	(95,398)
Prepaid expenses (increase) decrease	74,099
Accounts payable increase (decrease)	168,299
Accrued liabilities (decrease)	(399,905)
Net cash provided by operations	394,586
CASH FLOWS FROM INVESTING ACTIVITIES:	
Acquisition of property and equipment (net)	(24,594)
Net cash (used in) investing activities	(24,594)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from issuance of common shares due to exercise of stock options	62,972
Net cash provided by financing activities	62,972
NET INCREASE IN CASH AND CASH EQUIVALENTS	432,964
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	7,069,542
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 7,502,506

Supplemental Disclosure of Non cash investing activities:	
Demonstration and no-cap sales equipment capitalized from inventory (Note 2)	$ 114,329

See notes to financial statements

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

FEBRUARY 28, 2005

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 three-month period ended February 28, 2005 do not necessarily indicate the results that you should expect for the year ending November 30, 2005. You should read the unaudited interim financial statements together with the financial statements and related notes for the year ended November 30, 2004 included in our Annual Report on Form 10-K for the fiscal year ended November 30, 2004.

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:

	February 28, 2005	November 30, 2004
Purchased components ...	$340,003	$323,053
Finished goods	302,968	358,815
Work in process	21,008	1,042
Total	$663,979	$682,910

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 no-cap sales equipment and are depreciated over five years. During the first quarter of fiscal 2005 and fiscal 2004, costs capitalized from inventory for Cerebral Oximeters being used as demonstration and no-cap sales equipment at customer locations were approximately $114,000 and $136,000, respectively. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the net book value of the asset may not be recovered.

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

	February 28, 2005	November 30, 2004
Patents and trademarks	111,733	111,733
Less accumulated amortization ...	(89,628)	(87,900)
Total	$ 22,105	$ 23,833

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

FEBRUARY 28, 2005

Amortization expense for the three months ended February 28, 2005 and February 29, 2004 was approximately $1,700. Amortization expense for each of the next three 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 System, and related products and accessories. In exchange for the licenses and consulting services, we agreed to the following compensation for CorRestore LLC and its agent, Joe B. Wolfe: (1) a royalty of 10% of our "net sales" of products subject to the licenses, (2) five-year warrants to purchase up to 400,000 common shares at $3.00 a share, exercisable to purchase 300,000 shares immediately and to purchase an additional 50,000 shares upon our receipt of clearance or approval from the FDA to market the CorRestore Patch in the United States and another 50,000 shares upon our receipt of CE certification for the CorRestore System, (3) additional five-year warrants to purchase up to 2,100,000 common shares at $3.00 a share, granted when we received clearance from the FDA to market the CorRestore Patch in the United States, exercisable based on our cumulative net sales of the CorRestore System products, and (4) a consulting fee of $25,000 a year to each of the inventors until we sell 1,000 CorRestore Patches. 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.

License acquisition costs consist of professional service fees recorded at cost, our estimate of the fair value of the ten-year vested stock options to purchase 50,000 common shares at $3.00 a share granted to one of our then current directors in connection with negotiating and assisting us in completing the transaction, and our estimate of the fair value of the 400,000 common share vested portion of the five-year warrants to purchase common shares at $3.00 a share issued in the transaction. Consistent with the treatment of the warrants to purchase 400,000 common shares, we intend to include in license acquisition costs, and additional paid in capital, the fair value of the vested portion of the warrants to purchase 2,100,000 common shares, estimated using the Black-Scholes valuation model, when and if they become vested. However, we do not expect any of these warrants to become vested before their November 21, 2006 expiration date, based on sales of CorRestore products to date.

The total carrying amount of these license acquisition costs is as follows:

	February 28, 2005	November 30, 2004
License acquisition costs........	$ 929,093	$ 929,093

License acquisition costs are intangible assets with indefinite lives that are reviewed annually for impairment at the end of our fiscal year, and whenever events or changes in circumstances indicate that the carrying value of the asset may not be recovered. We evaluate impairment by comparing the fair value of the intangible asset, determined using a cash flow method, with its carrying value.

Stock Options In October 1995, Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," was issued. In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised), Share Based Payment. This Statement, which is effective for interim or annual reporting periods that begin after June 15, 2005, revises Statement No. 123, "Accounting for Stock-Based Compensation," and requires that compensation costs related to share-based payment transactions, including stock options, restricted stock and restricted stock units be recognized in the financial statements. This Statement will be effective for our fiscal quarter ending November 30, 2005. We

expect the equity compensation to be recognized in our statement of operations for fiscal 2005, related to unvested stock options as of our required adoption date, will be the equivalent of $.01 per diluted common share, and we expect the impact for fiscal 2006 will be approximately $.03 per diluted common share. The future approval of any additional equity incentive plans would have an additional impact on our financial statements.

We currently 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 quarter of fiscal 2005 we did not grant any stock options, and four of our employees and one of our former consultants exercised stock options to purchase 9,500 newly-issued common shares. During the first quarter of fiscal 2004, we granted 20,000 stock options to our employees, and four of our employees and one of our former directors exercised stock options to purchase 15,011 newly-issued common shares.

Had compensation expense for stock options that vested in the first quarter been determined based on the fair value of the options on the grant date pursuant to the methodology of SFAS No. 123, our results of operations, on a pro forma basis, would have been as follows:

	FOR THE QUARTER ENDED FEBRUARY 28, 2005	FOR THE QUARTER ENDED FEBRUARY 29, 2004
Net income	$ 563,926	$ 292,744
Add: Stock-based employee compensation included in actual net income	$ 0	$ 0
Deduct: Total stock-based employee compensation expense, had fair value method been applied	$(197,268)	$(178,209)
Pro-forma net income	$ 366,658	$ 114,535
Net income per common share - diluted ...	$ .05	$ .03
Pro forma net income per common share - diluted	$ .03	$ .01

Net Income 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 includes the potential dilution that could occur for common stock issuable under stock options or warrants. The difference between weighted average shares - diluted and weighted average shares - basic is calculated as follows:

	February 28, 2005	February 29, 2004
Weighted average shares - basic	10,140,015	9,308,607
Add: effect of dilutive common shares and warrants	1,700,078	1,987,688
Weighted average shares - diluted	11,840,093	11,296,295

For the quarters ended February 28, 2005 and February 29, 2004, the number of stock options that were excluded from the computation of net income per common share - diluted, because the exercise price of the options exceeded the average price per share of our common stock, was approximately 500 and 87,000, respectively. For the quarters ended February 28, 2005 and February 29, 2004, the number of warrants that were excluded from the computation, because the warrants are contingent on achieving specified future sales targets that we do not expect to achieve, was approximately 2,100,000 and 1,633,000, respectively. As of February 28, 2005 and February 29, 2004, we had outstanding warrants and options to purchase common shares of 4,426,815 and 5,300,841, respectively.

Reclassifications Certain reclassifications have been made to the financial statements for 2004 to conform to 2005 presentation.

3. ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	February 28, 2005	November 30, 2004
Incentive compensation	$135,000	$390,978
Sales commissions	75,712	153,180
Professional fees	55,000	42,000
Royalty	12,907	9,130
Warranty	12,500	10,750
401(k) match	12,085	97,071
Total	$303,204	$703,109

4. COMMITMENTS AND CONTINGENCIES

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

5. COMMON STOCK

During the first quarter of fiscal 2005, we issued 9,500 newly-issued common shares as a result of stock option exercises by employees and a former consultant, for proceeds of approximately $63,000.

On February 24, 2005, our Board of Directors adopted the Somanetics Corporation 2005 Stock Incentive Plan, subject to shareholder approval at the 2005 Annual Meeting of Shareholders. The Plan permits us to grant stock options, including both nonqualified options and incentive options, restricted stock and restricted stock units to our officers, other employees, non-employee directors, consultants, advisors, independent contractors and agents, up to 600,000 common shares.

FEBRUARY 28, 2005

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 97% of our net revenues in the first quarter of fiscal 2005 were derived from our INVOS Cerebral Oximeter product line, compared to 92% of our net revenues in the first quarter of fiscal 2004.

SOMANETICS CORPORATION

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

FEBRUARY 28, 2005

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 of 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 infringement 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 2004 and the first quarter of fiscal 2005, 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 an increase in net income before income taxes of approximately 192%, primarily as a result of an increase in net revenues of approximately 51% and an increase in gross margin percentage to approximately 86%. 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 increased international sales. Our increase in gross margin percentage was also primarily attributable to the increase in average selling prices for our disposable SomaSensors, as well as the reduction in the cost of our disposable SomaSensor by approximately 40%, effective May 2004, as a result of changes in our manufacturing process. Our operating expenses increased approximately 43% for the quarter primarily due to our hiring additional sales personnel in fiscal 2004 and 2005, and increased commissions paid to our independent sales representative firms and direct sales employees as a result of increased sales. We had approximately $395,000 of cash provided by operations in the first quarter of fiscal 2005, and a net increase in cash and cash equivalents of approximately $433,000.

For 2005, we project an increase in net revenues of approximately 47% to 52%, and we also project an increase in net income before income taxes of approximately 70% to 80%, to approximately $3.4 million to $3.6 million. In addition, we expect to realize a net increase in cash and cash equivalents of approximately $3 million, to approximately $10 million. While we do not expect to pay income taxes for fiscal 2005, beginning in the first quarter of 2005, we began recognizing income tax expense at an estimated effective tax rate of 34% on our statement of operations. As 2005 progresses and we assess our plans for future years, we will review the appropriateness of adjusting our deferred tax asset valuation allowance and recognizing additional net deferred tax assets.

THREE MONTHS ENDED FEBRUARY 28, 2005 COMPARED TO THREE MONTHS ENDED FEBRUARY 29, 2004

Our net revenues increased $1,362,352, or 51%, from $2,670,265 in the three-month period ended February 29, 2004 to $4,032,617 in the three-month period ended February 28, 2005. The increase in net revenues is primarily attributable to

- an increase in United States sales of approximately $1,081,000, or 47%, from approximately $2,283,000 in the first quarter of fiscal 2004 to approximately $3,364,000 in the first quarter of fiscal 2005. This increase is primarily due to an increase in sales of the disposable SomaSensor of approximately $1,063,000, or 57%, as a result of a 37% increase in SomaSensor unit sales and a 15% increase in SomaSensor average selling prices, and an increase in Cerebral Oximeter revenues of approximately $75,000, or 29%, due to increased purchases by pediatric hospitals. This increase was partially offset by a decrease in sales of the CorRestore System of approximately $56,000, or 34%, and

- an increase in international sales of approximately $281,000, or 73%, from approximately $387,000 in the first quarter of fiscal 2004 to approximately $668,000 in the first quarter of fiscal 2005, primarily attributable to increased purchases of the Cerebral Oximeter and SomaSensors by Tyco Healthcare.

As described above, during the first quarter we achieved a 15% increase in the average selling price of SomaSensors in the United States. The increase in the average selling price is primarily attributable to the addition of new customers at our higher suggested retail prices and increased sales of our pediatric SomaSensor, which sells for a premium price. In addition, as described above, we had a 37% increase in SomaSensor unit sales in the United States to 33,102 units. We expect that the average selling price of SomaSensors in the United States will increase by at least 10% in 2005 compared to 2004 as a result of the factors described above.

We placed 66 new Cerebral Oximeters in the United States in the first quarter of 2005, and we estimate that the installed base of Cerebral Oximeters in the United States is approximately 835, in approximately 410 hospital accounts, as of February 28, 2005.

Approximately 17% of our net revenues in the first quarter of fiscal 2005 were from export sales, compared to approximately 14% of our net revenues in the first quarter of fiscal 2004. We expect international net revenues to represent approximately 15% to 20% of total net revenues in 2005. During the first quarter of 2005, one international distributor (Europe) represented approximately 10% of our net revenues.

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

PRODUCT	PERCENT OF NET REVENUE FIRST QUARTER OF FISCAL 2005	2004
SomaSensors	80%	76%
Cerebral Oximeters	17%	16%
CorRestore Systems	3%	8%
Total	100%	100%

For 2005, 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 less than 5%.

Gross margin as a percentage of net revenues was approximately 86% for the quarter ended February 28, 2005 and approximately 81% for the quarter ended February 29, 2004. 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 the reduction in the cost of our SomaSensor by approximately 40%, in May 2004, as a result of changes in our manufacturing process. We expect our gross margin percentage to be approximately 87% in fiscal 2005, primarily due to the factors described above.

Our research, development and engineering expenses increased approximately $8,000, or 9%, from $87,690 for the three months ended February 29, 2004 to $95,802 for the three months ended February 28, 2005. The increase is primarily attributable to increased development costs associated with the Cerebral Oximeter.

Selling, general and administrative expenses increased approximately $801,000, or 45%, from $1,774,900 for the three months ended February 29, 2004 to $2,576,136 for the three months ended February 28, 2005, primarily due to a 66% increase in our sales and marketing expenses during the first quarter of fiscal 2005 because of our increased sales headcount and our increased sales and marketing efforts. The increase in selling, general and administrative expense is primarily attributable to

- a $242,000 increase in travel, trade show and selling-related expenses as a result of our increased sales headcount and increased sales and marketing efforts,

- a $213,000 increase in salaries, wages, and related expenses, primarily as a result of an increase in the number of employees, principally sales and marketing (from an average of 28 employees for the first quarter ended February 29, 2004 to an average of 37 employees for the first quarter ended February 28, 2005),

- a $153,000 increase in commissions paid to our sales employees, as a result of hiring additional sales employees in fiscal 2004 and 2005 and increased sales,

- an $89,000 increase in commissions paid to our independent sales representative firms as a result of increased sales,

- a $63,000 increase in accrued incentive compensation expense due to our year-to-date 2005 financial performance, primarily increased sales and net income, in accordance with the 2005 Incentive Compensation Plan, and

- $38,000 in costs for the first quarter of fiscal 2005 associated with our employer 401(k) matching program, which was implemented in the fourth quarter of fiscal 2004.

We expect our selling, general and administrative expenses to further increase in fiscal 2005, primarily as a result of our current plans to hire additional direct sales personnel in fiscal 2005, increased sales commissions payable to our independent sales representative firms as sales increase and increased sales and marketing expenses.

During the first quarter of fiscal 2005, we began recognizing income tax expense at an estimated effective tax rate of 34% on our statement of operations, and we expect this to continue for future periods.

For the three-month period ended February 28, 2005, we realized net income of $.05 per diluted common share, compared to $.03 per diluted common share for the first quarter of 2004. The increase in net income per diluted common share is primarily attributable to

- a 51% increase in net revenues, and

- a 5% increase in gross margin percentage.

We achieved the increase in net income despite a 43% increase in operating expenses and the recognition of income tax expense.

LIQUIDITY AND CAPITAL RESOURCES

Net cash provided by operations during the three-month period ended February 28, 2005 was approximately $395,000. Cash was provided primarily by

- net income of approximately $564,000, non-cash income tax expense of approximately $291,000, and depreciation and amortization expense of approximately $83,000,

- an increase in accounts payable of approximately $168,000, primarily because of increased inventories, increased operating expenses, and the timing of payments to vendors, and

- a decrease in prepaid expenses of approximately $74,000, primarily because of the amortization of prepaid insurance payments made in fiscal 2004.

CONDITION AND RESULTS OF OPERATIONS

FEBRUARY 28, 2005

Cash provided by operations was partially offset by

- a decrease in accrued liabilities of approximately $400,000, primarily due to payments made in the first quarter for incentive compensation, sales commissions for employees, and employer 401(k) matching contributions,

- an increase in accounts receivable of approximately $290,000, primarily because of higher first quarter 2005 sales, and

- an increase in inventories of approximately $95,000, primarily due to the increased acquisition of SomaSensors and components associated with our Cerebral Oximeter.

Inventories on our balance sheet declined because we capitalized Cerebral Oximeters that are being used as demonstration units and no-cap sales equipment. We capitalized approximately $114,000 of costs from inventory for Cerebral Oximeters being used as demonstration units and no-cap sales equipment at customer locations during the first quarter of 2005, compared to approximately $136,000 in the first quarter of fiscal 2004. We depreciate these assets over five years.

In addition, we had capital expenditures in the first three months of fiscal 2005 of approximately $25,000. These expenditures were primarily for tooling for the SomaSensor.

During the first quarter of fiscal 2005, we issued 9,500 common shares as a result of stock option exercises by employees and a former consultant, for proceeds of approximately $63,000.

As of February 28, 2005, we had working capital of $10,236,912, cash and cash equivalents of $7,502,506, total current liabilities of $1,000,600 and shareholder's equity of $18,179,564. We had an accumulated deficit of $44,318,221 through February 28, 2005.

We believe that the cash and cash equivalents on hand at February 28, 2005 will be adequate to satisfy our operating and capital requirements for more than the next twelve months. For 2005, we expect to realize positive cash flow from operations, as well as a net increase in cash and cash equivalents, with year-end cash on hand expected to be approximately $10,000,000.

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, our accounting treatment for income taxes, and our revenue recognition associated with our no-cap sales program.

FEBRUARY 28, 2005

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. Consistent with the treatment of the vested warrants to purchase commmon shares, we intend to include in license acquisition costs, and additional paid in capital, the fair value of the vested portion of the unvested warrants to purchase common shares, estimated using the Black-Scholes valuation model, when and if they become vested. However, we do not expect any of these remaining warrants to become vested before their November 21, 2006 expiration date, based on sales of CorRestore products to date.

We estimated the value of the stock options to purchase common shares and the vested 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, we recorded no amortization expense related to these license acquisition costs in fiscal 2005 or 2004. 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. Indefinite lived intangible assets are reviewed annually for impairment at the end of our fiscal year, and whenever events or changes in circumstances indicate that the carrying value of the asset may not be recovered. We evaluate impairment by comparing the fair value of the intangible asset, determined using a cash flow method, with its carrying value.

In October 1995, Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," was issued. In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised), Share Based Payment. This Statement, which is effective for interim or annual reporting periods that begin after June 15, 2005, revises Statement No. 123, "Accounting for Stock-Based Compensation," and requires that compensation costs related to share-based payment transactions, including stock options, stock appreciation rights and restricted stock be recognized in the financial statements. This Statement will be effective for our fiscal quarter ending November 30, 2005.

SOMANETICS CORPORATION

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We currently 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 quarter of fiscal 2005, we did not grant any stock options to our employees, and during the first quarter of fiscal 2004, we granted 20,000 stock options to our employees.

Had we recognized compensation expense for stock options that vested in the first quarter of fiscal 2005 and 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 $197,000, or $.02 per diluted common share, and $178,000, or $.02 per diluted common share, respectively.

During fiscal 2004, we adjusted our deferred tax asset valuation allowance resulting in the recognition of a deferred tax asset of $6,700,000 related to the expected future benefits of our net operating loss carryforwards, in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." We have performed the required assessment of positive and negative evidence regarding realization of our deferred tax assets in accordance with SFAS No. 109, including our past operating results, the existence of cumulative losses over our history up to the most recent two fiscal years, and our forecast for future net income. The primary assumption underlying our determination that the net asset will be realized is that our revenues and pre-tax income will grow in future years consistent with the growth guidance given for fiscal 2005. Our assessment of our deferred tax assets, and the reversal of part of our valuation allowance, included evaluating our financial plans and our future projected earnings, making allowance for the uncertainties surrounding, among other things, our future rate of growth in net revenues, the rate of adoption of our products in the marketplace, and the potential for competition to enter the marketplace.

In reversing a portion of our valuation allowance, we have concluded that it is more likely than not that such assets will be realized. Given the assumptions inherent in our financial plans, it is possible to calculate a different value for our deferred tax asset by changing one or more of the variables in our assessment. However, we believe that our evaluation of our financial plans was reasonable, and that the judgments and assumptions that we made at the time of developing the plan were appropriate.

During the first quarter of fiscal 2005, we began recognizing income tax expense at an estimated effective tax rate of 34% on our statement of operations. As 2005 progresses and we assess our plans for future years, we will review the appropriateness of adjusting our deferred tax asset valuation allowance and recognizing additional net deferred tax assets.

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 SomaSensor revenue when we receive purchase orders and ship the product to the customer. Under our no-cap sales program, we do not recognize any revenue upon the initial shipment of the Cerebral Oximeter. At the time of shipment, we capitalize the Cerebral Oximeter as an asset and depreciate this asset over five years. We believe this is consistent with our stated revenue recognition policy, which is compliant with Staff Accounting Bulletin No. 104 and Emerging Issues Task Force No. 00-21, "Revenue Arrangements with Multiple Deliverables."

SOMANETICS CORPORATION

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FEBRUARY 28, 2005

CONTRACTUAL OBLIGATIONS

As of February 28, 2005, there have been no material changes outside the ordinary course of business in the contractual obligations disclosed in our Annual Report on Form 10-K for the fiscal year ended November 30, 2004 under the caption "Contractual Obligations".

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

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 February 28, 2005, and, based on their evaluation, our principal executive and principal financial officers have concluded that these controls and procedures are effective as of February 28, 2005. There was no change in our internal control over financial reporting identified in connection with such evaluation that occurred during our first fiscal quarter ended February 28, 2005 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.

PART II OTHER INFORMATION

ITEM 6. EXHIBITS

10.1 Somanetics Corporation 2005 Stock Incentive Plan, incorporated by reference to Exhibit 10.1 to the Somanetics Corporation Current Report on Form 8-K, dated February 24, 2005.

31.1 Certifications of Chief Executive Officer Pursuant to Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certifications of Chief Financial Officer Pursuant to Rule 13a-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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

Somanetics Corporation
(Registrant)

Date: April 11, 2005

By: /s/ William M. Iacona

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

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EXHIBIT INDEX

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