SOMANETICS CORP
Form 10-Q
September 30, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended August 31, 2008

OR

o **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)
N/A
(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.
Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No þ

Number of common shares outstanding at September 30, 2008: **12,009,074**

PART I FINANCIAL INFORMATION
SOMANETICS CORPORATION
BALANCE SHEETS

	August 31, 2008 (Unaudited)	November 30, 2007 (Audited)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 41,202,691	$ 33,172,977
Marketable securities	3,996,915	18,978,074
Accounts receivable	7,735,537	7,486,571
Inventory	2,803,061	1,998,284
Prepaid expenses	262,741	560,885
Accrued interest receivable	253,166	551,117
Deferred tax asset current	1,047,633	3,069,929
Total current assets	57,301,744	65,817,837
PROPERTY AND EQUIPMENT (at cost):		
Demonstration and no capital cost sales equipment at customers	3,709,459	3,386,287
Machinery and equipment	1,589,381	1,531,387
Furniture and fixtures	497,087	307,919
Leasehold improvements	197,450	196,700
Total	5,993,377	5,422,293
Less accumulated depreciation and amortization	(3,230,891)	(2,931,596)
Net property and equipment	2,762,486	2,490,697
OTHER ASSETS:		
Long-term investments	20,993,111	33,653,099
Deferred tax asset non-current	1,361,738	3,004,755
Other	15,000	15,000
Intangible assets, net		3,097
Total other assets	22,369,849	36,675,951
TOTAL ASSETS	$ 82,434,079	$ 104,984,485
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 1,056,552	$ 1,118,003
Accrued liabilities	1,341,740	1,701,481
Total current liabilities	2,398,292	2,819,484
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, 12,009,074 shares at August 31, 2008, and 13,443,961 shares at November 30, 2007	120,091	134,440
Additional paid-in capital	89,837,382	119,079,383
Accumulated deficit	(9,921,686)	(17,048,822)
Total shareholders equity	80,035,787	102,165,001
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 82,434,079	$ 104,984,485

See notes to financial statements

SOMANETICS CORPORATION
STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2008	**2007**	**2008**	**2007**
NET REVENUES	$ 12,367,988	$ 10,163,509	$ 33,801,326	$ 27,310,559
COST OF SALES	1,717,858	1,338,418	4,413,939	3,387,258
Gross Margin	10,650,130	8,825,091	29,387,387	23,923,301
OPERATING EXPENSES:				
Research, development and engineering	332,236	157,657	894,574	435,445
Selling, general and administrative	6,155,551	5,444,836	19,423,534	16,034,364
Total operating expenses	6,487,787	5,602,493	20,318,108	16,469,809
OPERATING INCOME	4,162,343	3,222,598	9,069,279	7,453,492
OTHER INCOME:				
Interest income	562,178	1,008,749	2,197,280	2,974,835
Total other income	562,178	1,008,749	2,197,280	2,974,835
INCOME BEFORE INCOME TAXES	4,724,521	4,231,347	11,266,559	10,428,327
INCOME TAX EXPENSE	(1,678,067)	(1,438,658)	(4,139,424)	(3,545,631)
NET INCOME	$ 3,046,454	$ 2,792,689	$ 7,127,135	$ 6,882,696
NET INCOME PER COMMON SHARE BASIC	$ 0.25	$ 0.21	$ 0.55	$ 0.52
NET INCOME PER COMMON SHARE DILUTED	$ 0.23	$ 0.19	$ 0.51	$ 0.47
WEIGHTED AVERAGE SHARES OUTSTANDING BASIC	12,079,089	13,186,754	12,889,638	13,174,355

WEIGHTED AVERAGE SHARES OUTSTANDING DILUTED	13,247,953	14,549,298	13,919,212	14,579,710

See notes to financial statements

SOMANETICS CORPORATION
STATEMENTS OF CASH FLOWS
(Unaudited)

	For the Nine-Month Periods Ended August 31, 2008	For the Nine-Month Periods Ended August 31, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 7,127,135	$ 6,882,696
Adjustments to reconcile net income to net cash provided by operations:		
Income tax expense	3,837,802	3,545,631
Depreciation and amortization	702,601	590,975
Stock compensation expense	954,993	564,452
Changes in assets and liabilities:		
Accounts receivable (increase)	(248,966)	(1,864,652)
Accrued interest income decrease (increase)	297,951	(245,989)
Inventory (increase)	(1,183,438)	(943,553)
Deferred income tax benefit (increase)	(172,488)	(365,960)
Prepaid expenses decrease	298,144	292,764
Accounts payable (decrease)	(61,451)	(85,426)
Accrued liabilities (decrease)	(359,741)	(3,618)
Accrued income tax expense decrease		194,000
Net cash provided by operating activities	11,192,542	8,561,320
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of marketable securities and long-term investments		(38,122,251)
Proceeds from maturities of marketable securities and long-term investments	27,641,147	27,000,000
Acquisition of property and equipment	(592,633)	(205,195)
Net cash provided by (used in) investing activities	27,048,514	(11,327,446)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repurchase of common shares	(31,449,420)	
Proceeds from issuance of common shares due to exercise of stock options	1,238,078	184,871
Net cash (used in) provided by financing activities	(30,211,342)	184,871
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	8,029,714	(2,581,255)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	33,172,977	28,734,869
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 41,202,691	$ 26,153,614

Supplemental Disclosure of Non cash investing activities:				
Demonstration and no capital cost sales equipment capitalized from inventory (Note 2)	$	378,661	$	616,176
Supplemental Disclosure of Taxes paid:				
Federal and state income taxes (Note 3)	$	474,110	$	479,858

See notes to financial statements

SOMANETICS CORPORATION
Notes to Financial Statements
(Unaudited)
August 31, 2008

1. FINANCIAL STATEMENT PRESENTATION

We prepared our unaudited interim financial statements pursuant to the Securities and Exchange Commission s rules. These interim financial statements 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 for a fair statement of the results for the interim periods presented. All of these adjustments that are material are of a normal recurring nature. Our operating results for the nine-month period ended August 31, 2008 do not necessarily indicate the results that you should expect for the fiscal year ending November 30, 2008. You should read the unaudited interim financial statements together with the financial statements and related notes for the fiscal year ended November 30, 2007 included in our Annual Report on Form 10-K for the fiscal year ended November 30, 2007.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Marketable Securities and Long-Term Investments consist of Aaa-rated United States government agency bonds, classified as held to maturity, maturing approximately two to five years from the date of acquisition, are stated at an amortized cost of $24,990,026, and have a market value of $25,028,728 at August 31, 2008.

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

	August 31, 2008	**November 30, 2007**
Purchased components	$ 1,990,942	$ 1,702,878
Finished goods	568,586	174,451
Work in process	243,533	120,955
Total	$ 2,803,061	$ 1,998,284

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 ten years. Depreciation expense was $699,504 and $585,793 for the nine-month periods ended August 31, 2008 and August 31, 2007, respectively. We offer to our United States customers a no capital cost sales program whereby we ship the INVOS System monitor to the customer at no charge. The INVOS System monitors that are shipped to our customers are classified as no capital cost sales equipment and are depreciated over five years to cost of goods sold. All other depreciation expense is recorded as a selling, general and administrative expense. As of August 31, 2008, we have capitalized $3,709,459 in costs for INVOS System monitors being used as demonstration and no capital cost sales equipment, and these assets had a net book value of $1,713,308. As of November 30, 2007, we have capitalized $3,386,287 in costs for INVOS System monitors being used as demonstration and no capital cost sales equipment, and these assets had a net book value of $1,801,702. 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. Patents and trademarks are recorded at cost and have been amortized on the straight-line method over 17 years. The carrying amount and accumulated amortization of these patents and trademarks are as follows:

SOMANETICS CORPORATION
Notes to Financial Statements- Continued
(Unaudited)
August 31, 2008

	August 31, 2008	November 30, 2007
Patents and trademarks	$ 111,733	$ 111,733
Less: accumulated amortization	(111,733)	(108,636)
Total	$	$ 3,097

Amortization expense for the nine months ended August 31, 2008 and August 31, 2007 was approximately $3,100 and $5,200 respectively. Amortization expense for fiscal 2008 is expected to be approximately $3,100.

Stock Compensation For the first three quarters of fiscal 2008, we have recorded stock compensation expense of $954,993 as a result of stock options and restricted common shares granted to our officers, employees, directors and one of our consultants. For the first three quarters of fiscal 2007, we recorded stock compensation expense of $564,452. During the first nine months of fiscal 2008, we granted 197,500 stock options to our officers and employees in March 2008 at an exercise price of $12.61, we granted 50,000 stock options to our directors in April 2008 at an exercise price of $16.82, and we granted 5,500 stock options to two new employees in June 2008 at an exercise price of $18.19. In addition, we issued 70,000 restricted common shares to our officers in March 2008 with a market value of $12.61 per share on the date of grant, and we issued 5,273 restricted common shares to our employees in January 2008 with a market value of $21.81 per share on the date of grant. During the first nine months of fiscal 2007, we granted 50,000 stock options to five of our directors in June 2007 at an exercise price of $19.33, and we granted 16,000 stock options to one of our officers and two of our employees in April 2007 at an exercise price of $18.85. These options described above were granted under the 2005 Stock Incentive Plan, expire 10 years after grant and were granted at the closing sale price of the common shares as of the date of grant. The weighted-average grant-date fair value of the options granted during the first nine months of fiscal 2008 and fiscal 2007 was $7.83 and $9.95, respectively. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: expected volatility (the measure by which the stock price has fluctuated or is expected to fluctuate during the period) 59.30 percent for 2008 and 47.00 percent for 2007, risk-free interest rate (approximate U.S. Treasury yield in effect at the time of grant) 2.35 percent for 2008 and 5.0 percent for 2007, expected lives of approximately 6 years and a dividend yield of 0 percent. The fair value of the restricted common shares was estimated based on the market value of the common shares on the date of issuance.

During the first three quarters of fiscal 2008, 59,400 stock options and 13,600 restricted common shares vested, and the total fair value of shares vested during the first nine months of fiscal 2008 was $828,114. During the first three quarters of fiscal 2007, 46,400 stock options and 13,600 restricted common shares vested, and the total fair value of shares vested during the first nine months of fiscal 2007 was $698,781. During the nine months ended August 31, 2008, 294,969 stock options were exercised by our employees and directors for gross proceeds to us of $1,238,078. The intrinsic value of these exercised stock options was $5,227,929. During the nine months ended August 31, 2007, 30,834 stock options were exercised by our employees, a former director, and a consultant for gross proceeds to us of $184,871. The intrinsic value of these exercised stock options was $386,643.

As of August 31, 2008, there was $5,631,388 of total unrecognized compensation cost related to nonvested share-based compensation awards granted under the 2005 Plan. This cost is expected to be recognized over a weighted average period of approximately 4.25 years. In addition, as of August 31, 2008, the aggregate intrinsic value of stock options outstanding was $30,921,910, and the aggregate intrinsic value of stock options exercisable was $26,204,816.

No modifications were made to any share awards that required an accounting charge, and no cash was paid for share-based liabilities during the first three quarters of fiscal 2008 or during the first three quarters of fiscal 2007.

SOMANETICS CORPORATION
Notes to Financial Statements- Continued
(Unaudited)
August 31, 2008

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 shares issuable under stock options. The difference between weighted average shares diluted and weighted average shares basic is calculated as follows:

	2008	
	Three Months	Nine Months
Weighted average shares basic	12,079,089	12,889,638
Add: effect of dilutive common shares	1,168,864	1,029,574
Weighted average shares diluted	13,247,953	13,919,212

	2007	
	Three Months	Nine Months
Weighted average shares basic	13,186,754	13,174,355
Add: effect of dilutive common shares and warrant	1,362,544	1,405,355
Weighted average shares diluted	14,549,298	14,579,710

For the three and nine months ended August 31, 2008 and August 31, 2007 there were no stock options outstanding that were excluded from the computation of net income per common share diluted. As of August 31, 2008 we had outstanding 1,847,187 stock options to purchase common shares, and as of August 31, 2007 we had outstanding 2,106,156 stock options to purchase common shares.

Common Share Repurchase Program In April 2008, our Board of Directors authorized the repurchase of up to $15 million of our common shares. Purchases may be made from time to time in the open market or in privately negotiated transactions. The prices, timing and amount of, and purposes for, any purchases will be determined by management. In May 2008, our Board of Directors authorized the repurchase of up to an additional $15 million of our common shares, and in July 2008, our Board of Directors authorized the repurchase of up to an additional $15 million of our common shares, for a total of $45 million of our common shares under the repurchase program. During the first nine months of fiscal 2008, we repurchased 1,805,129 common shares at an average price of $17.42 per share and an aggregate cost of $31,449,420.

Accounting Pronouncements In July 2006, the FASB adopted FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 prescribes a recognition threshold and requires an assessment of the probability of the validity of tax positions taken or expected to be taken in income tax returns for recognition in financial statements. Only tax positions meeting a more-likely-than-not threshold of being sustained are recognized under FIN 48. FIN 48 also provides guidance on classification of interest and penalties and accounting and disclosures for annual and interim financial statements. We adopted FIN 48 effective December 1, 2007. The cumulative effect of the changes arising from the initial application of FIN 48 is required to be reported as an adjustment to the opening balance of retained earnings in the period of adoption. The adoption of FIN 48 did not have a material impact on our financial statements.

3. <u>INCOME TAXES</u>

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 five fiscal years, and our forecast for future net income. Our assessment of our deferred tax assets included assuming that our net revenues and pre-tax income will grow in future years consistent with the growth guidance given for fiscal 2008 and making allowance for the uncertainties

7

SOMANETICS CORPORATION
Notes to Financial Statements- Continued
(Unaudited)
August 31, 2008

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. As of November 30, 2007, we concluded that it was more likely than not that approximately $6,075,000 of such assets would be realized. As of August 31, 2008, we have concluded that it is more likely than not that approximately $2,409,000 of 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 nine months of fiscal 2008, we recognized income tax expense on our statement of operations at an estimated effective tax rate of 37 percent as a result of certain additional state tax expenses recorded in the first quarter. We expect our effective tax rate for fiscal 2008 to approximate 36 percent. During the first nine months of fiscal 2007, we recognized income tax expense on our statement of operations at an estimated effective tax rate of 34 percent.

During the first nine months of fiscal 2008 we paid income taxes of approximately $172,500 for alternative minimum tax due, and approximately $301,610 for state income taxes due. During the first nine months of fiscal 2007 we paid income taxes of approximately $195,000 for alternative minimum tax due, and approximately $284,860 for state income taxes due.

4. ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	August 31, 2008	November 30, 2007
Incentive Compensation	$ 786,520	$ 958,642
Sales Commissions	394,958	548,046
Professional Fees	78,853	61,550
Clinical Research	60,639	110,639
Warranty	18,920	19,800
Royalty	1,850	2,804
Total	$ 1,341,740	$ 1,701,481

5. COMMITMENTS AND CONTINGENCIES

As of June 17, 2008, we have employment agreements or change in control agreements with all of our officers. The employment agreement with our Senior Vice President, U.S. Sales and Marketing and the change in control agreements with seven of our officers provide for severance benefits equal to one year s salary upon termination of employment without cause or for good reason 90 days before to one year after a change in control of the Company that occurs by June 17, 2011. In addition, on June 17, 2007, we amended and restated our employment agreement with our President and Chief Executive Officer that was scheduled to expire April 30, 2009. The amended and restated agreement provides for severance benefits consisting of fringe benefits for one year (two years if termination is in connection with a Change in Control) and a lump sum payment equal to one year s salary (two years if termination is in connection with a Change in Control), plus the target bonus for the year of termination (which must be at least 65% of his salary) (two times the target bonus if termination is in connection with a Change in Control), plus a pro rata bonus through the date of termination upon termination of his employment without cause or for good reason. His amended and restated employment agreement expires June 17, 2011, unless earlier terminated as provided in the agreement, except that the term is automatically extended for additional one-year periods effective one year before it would otherwise expire (i.e., so that the remaining term will be two years),

SOMANETICS CORPORATION
Notes to Financial Statements- Continued
(Unaudited)
August 31, 2008

unless either party provides the other with notice that the term will not be extended and such notice is provided at least one year before the term would otherwise expire. All officers have agreed not to compete with us and not to solicit our employees during specified periods following the termination of employment, and they have agreed to various confidentiality obligations. The estimated financial exposure of these employment agreements, upon a change of control of the Company and termination of all of the executives without cause, is approximately $2,191,000.

We may become subject to product liability claims by patients or physicians, and may become a defendant in product liability or malpractice litigation.

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 100 percent of our net revenues in the first three quarters of fiscal 2008 and 2007 were derived from our INVOS System product line.

SOMANETICS CORPORATION
MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
August 31, 2008

Forward-Looking Statements

You should read the following discussion and analysis of our financial condition and results of operations together with our financial statements and the related notes and other financial data included elsewhere in this report. Some of the information contained in this discussion and analysis or set forth elsewhere in this report, including information with respect to our plans and strategy for our business, includes forward-looking statements that involve risks and uncertainties. You should review the Risk Factors section of our Annual Report on Form 10-K for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in the following discussion and analysis. See also Forward-Looking Statements in Item 1A of our Annual Report on Form 10-K.

Overview

We develop, manufacture and market the INVOS System, a non-invasive patient monitoring system that continuously measures changes in the blood oxygen levels in the brain and elsewhere in the body in patients with or at risk for restricted blood flow. We are currently expanding the use of our INVOS System in the pediatric and neonatal ICU s with the launch of our smaller sensor in the first quarter of fiscal 2008. We are also currently sponsoring a clinical trial evaluating the use of the INVOS System on diabetic patients over age 50. If results of this trial are positive, we intend to target more actively the sale of the INVOS System for use in diabetic patients undergoing major general surgeries, consistent with FDA requirements.

In November 2005, we received 510(k) clearance from the FDA to market our INVOS System to monitor changes in somatic tissue blood oxygen saturation in regions of the body other than the brain in patients with or at risk for restricted blood flow. In May 2008, we received 510(k) clearance from the FDA to market our INVOS System to monitor changes in blood oxygen saturation in any tissues beneath the sensor, not limited to brain and skeletal muscle tissue. Our four-channel cerebral and somatic INVOS System monitor, which we launched in the second quarter of 2006, can display information from four SomaSensors, which allows for the simultaneous monitoring of changes in blood oxygen saturation in the tissue beneath the sensor in patients with or at risk for restricted blood flow.

Net Revenues and Cost of Sales

We derive our revenues primarily from sales of INVOS Systems to hospitals in the United States through our direct sales team and independent sales representative firms. Outside the United States, we have distribution agreements with independent distributors for the INVOS System, including Covidien, formerly Tyco Healthcare, in Europe, Canada, the Middle East and South Africa, and Edwards Lifesciences Ltd. in Japan. Our cost of sales represent the cost of producing monitors and disposable SomaSensors. Revenues from outside the United States contributed 20 percent to our first nine months of fiscal 2008 net revenues. As a percentage of net revenues, the gross margins from our international sales are typically lower than gross margins from our U.S. sales, reflecting the difference between the prices we receive from distributors and from direct customers.

We offer to our customers in the United States a no capital cost sales program whereby we ship the INVOS System monitor to the customer at no charge. Under this program, we do not recognize any revenue upon the shipment of the monitor. At the time of shipment of the monitor, we capitalize the monitor as an asset and depreciate this asset over five years, and this depreciation is included in cost of goods sold. We recognize SomaSensor revenue when we receive purchase orders and ship the product to the customer.

Operating Expenses

Selling, general and administrative expenses generally consist of:

SOMANETICS CORPORATION
MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
August 31, 2008

salaries, wages and related expenses of our employees and consultants;

sales and marketing expenses, such as employee sales commissions, commissions to independent sales representatives, travel, entertainment, advertising, education and training expenses, depreciation of demonstration monitors and attendance at selected medical conferences;

clinical research expenses, such as costs of supporting clinical trials; and

general and administrative expenses, such as the cost of corporate operations, professional services, stock compensation, insurance, warranty and royalty expenses, investor relations, depreciation and amortization, facilities expenses and other general operating expenses.

We have increased the size of our direct sales team and expect to increase the size of our U.S. direct sales team in fiscal 2008. In addition we are evaluating placing direct salespersons and clinical specialists in Europe to support Covidien. As a result, we expect selling, general and administrative expenses to increase in fiscal 2008. We also expect increased sales and marketing expenses and increased stock compensation expenses in fiscal 2008.

Research, development and engineering expenses consist of:

salaries, wages and related expenses of our research and development personnel and consultants;

costs of various development projects; and

costs of preparing and processing applications for FDA clearance of new products.

Results of Operations

Three Months Ended August 31, 2008 Compared to Three Months Ended August 31, 2007

Net Revenues. Our net revenues increased $2,204,479, or 22 percent, from $10,163,509 in the three-month period ended August 31, 2007 to $12,367,988 in the three-month period ended August 31, 2008. The increase in net revenues is primarily attributable to:

an increase in U.S. sales of $1,718,331, or 22 percent, from $7,681,281 in the third quarter of fiscal 2007 to $9,399,612 in the third quarter of fiscal 2008. The increase in U.S. sales was primarily due to an increase in sales of the disposable SomaSensor of $1,461,130, or 22 percent, primarily as a result of a 15 percent increase in SomaSensor unit sales. In addition, sales of the INVOS System monitor in the United States increased $265,901, or 26 percent, primarily as a result of increased purchases by pediatric hospitals; and

an increase in international sales of $486,148, or 20 percent, from $2,482,228 in the third quarter of fiscal 2007 to $2,968,376 in the third quarter of fiscal 2008. The increase in international sales was primarily due to increased purchases of our INVOS System monitor of $670,706 by Covidien, formerly Tyco Healthcare, in Europe. This increase was partially offset by $276,398 in decreased purchases of the INVOS System monitor by Edwards Lifesciences in Japan related to the 2007 launch of our four-channel cerebral and somatic INVOS System monitor in Japan, where Edwards purchased monitors partially for evaluation and demonstration purposes. In the third quarter of fiscal 2008 and fiscal 2007, international sales represented 24 percent of our net revenues. Purchases by Covidien accounted for 19 percent of net revenues in the third quarter of fiscal 2008, compared to 17 percent in the third quarter of fiscal 2007.

We sold 75,938 SomaSensors in the United States and 41,590 internationally in the third quarter of fiscal 2008. We placed 116 INVOS System monitors in the United States and 212 internationally in the third quarter of fiscal 2008, and our installed base of INVOS System monitors in the United States was 2,350, in 696 hospitals, as of August 31, 2008.

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

SOMANETICS CORPORATION
MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
August 31, 2008

	Three Months Ended August 31,	
Product	**2008**	**2007**
SomaSensors	75%	76%
INVOS System Monitors	25%	24%
Total	100%	100%

Gross Margin. Gross margin as a percentage of net revenues was 86 percent for the three months ended August 31, 2008 and 87 percent for the three months ended August 31, 2007. The decrease in our gross margin percentage is primarily attributable to increased international sales, due to the lower margins we receive on sales to our international distributors. This decrease was partially offset by a six percent increase in the average selling price of SomaSensors in the United States, which is attributable to increased sales of our pediatric SomaSensors, which sell for a higher price than the adult SomaSensor.

Research, Development and Engineering Expenses. Our research, development and engineering expenses increased $174,579, or 111 percent, from $157,657 in the third quarter of fiscal 2007 to $332,236 in the third quarter of fiscal 2008. The increase is primarily attributable to increased costs associated with advances to the design and performance features of the disposable SomaSensor of $72,288, and an increase in salaries of $57,869 due to the addition of research and development personnel in fiscal 2007 and 2008. We expect our research, development and engineering expenses to increase in fiscal 2008 primarily as a result of development costs associated with advances to the design and performance features of the INVOS System, including the disposable SomaSensor, and the hiring of additional research and development personnel.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased $710,715, or 13 percent, from $5,444,836 for the three months ended August 31, 2007 to $6,155,551 for the three months ended August 31, 2008, primarily due to:

a $650,124 increase in salaries, wages and related expenses, primarily as a result of an increase in the number of employees, principally in sales and marketing (from an average of 91 employees for the three months ended August 31, 2007 to an average of 105 employees for the three months ended August 31, 2008) and an increase in salaries of existing employees;

a $179,896 increase in stock compensation expense due to stock compensation issued to our officers, employees, directors and one of our consultants in fiscal 2008; and

a $130,964 increase in travel, marketing and selling-related expenses primarily as a result of our increased sales personnel and increased sales and marketing activities, including sales training and trade shows.

These increases were partially offset by:

a $132,747 decrease in commissions paid to our independent sales representative firms as a result of fewer independent sales representative firms; and

a $101,203 decrease in professional service fees, primarily due to decreased auditing and tax fees in the third quarter of 2008.

We expect our selling, general and administrative expenses to increase in fiscal 2008, primarily as a result of our hiring additional direct sales personnel in fiscal 2008, increased employee sales commissions payable as a result of increased sales, increased sales and marketing expenses and increased stock compensation expenses.

Other Income. During the thi