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MEDSTONE INTERNATIONAL INC/
Form 10-Q
May 14, 2002

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 March 31, 2002

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.

Yes No

The number of shares of the Common Stock of the registrant outstanding as of May 1, 2002 was 3,931,220.

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MEDSTONE INTERNATIONAL, INC.

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MEDSTONE INTERNATIONAL, INC.
CONSOLIDATED BALANCE SHEETS

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March 31,
2001

(Unaudited)

ASSETS

Current assets:

| | | |
|--|----|------------|
| Cash and cash equivalents | \$ | 1,465,085 |
| Short-term investments held to maturity | | 4,600,383 |
| Accounts receivable, less allowance for doubtful accounts of \$737,084 and \$477,180 at March 31, 2002 and December 31, 2001, respectively | | 3,865,087 |
| Inventories, less allowance for inventory obsolescence of \$582,417 and \$457,088 at March 31, 2002 and December 31, 2001, respectively | | 5,426,721 |
| Deferred tax assets | | 2,160,695 |
| Prepaid expenses and other current assets | | 628,513 |
| Total current assets | | 18,146,484 |

Buildings, property and equipment, at cost:

| | | |
|--|--|--------------|
| Building | | 359,324 |
| Lithotripters | | 13,500,987 |
| Equipment | | 2,303,530 |
| Furniture and fixtures | | 965,231 |
| Leasehold improvements | | 175,032 |
| | | 17,304,104 |
| Less accumulated depreciation and amortization | | (12,433,361) |
| Net property and equipment | | 4,870,743 |

| | | |
|---|----|------------|
| Goodwill, net | | 3,201,545 |
| Investment in unconsolidated subsidiaries | | 879,133 |
| Net investment in sale-type lease | | 308,432 |
| Other assets, net | | 114,501 |
| | \$ | 27,520,838 |

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:

| | | |
|---------------------------|----|-----------|
| Accounts payable | \$ | 888,959 |
| Accrued expenses | | 384,088 |
| Accrued income taxes | | --- |
| Accrued payroll expenses | | 288,901 |
| Customer deposits | | 27,100 |
| Deferred revenue | | 895,057 |
| Total current liabilities | | 2,484,105 |

| | | |
|--|--|---------|
| Deferred tax liabilities | | 562,534 |
| Minority interest | | 479,666 |
| Deferred rent | | 87,275 |
| Stockholders' equity: | | |
| Common stock - \$.004 par value, 20,000,000 shares authorized, 5,742,670 shares issued at both | | |

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| | |
|--|---------------|
| March 31, 2002 and December 31, 2001 | 22,971 |
| Additional paid-in capital | 19,646,388 |
| Accumulated earnings | 16,217,459 |
| Accumulated other comprehensive income | 3,039 |
| Treasury stock, at cost, 1,811,450 and 1,631,450 shares at March 31, 2002 and December 31, 2001, respectively | (11,982,599) |
| | ----- |
| Total stockholders' equity | 23,907,258 |
| | ----- |
| | \$ 27,520,838 |
| | ===== |

See accompanying notes

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MEDSTONE INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF INCOME
Three months ended March 31, 2002 and 2001
(Unaudited)

| | 2002 |
|--|--------------|
| | ----- |
| Revenues: | |
| Procedures, maintenance fees and fee-for-service | \$ 4,337,435 |
| Net equipment sales | 1,896,443 |
| Interest income | 82,123 |
| | ----- |
| Total revenues | 6,316,001 |
| Costs and operating expenses: | |
| Cost of procedures and maintenance fees | 2,426,949 |
| Cost of equipment sales | 1,474,909 |
| Research and development | 260,939 |
| Selling | 812,215 |
| General and administrative | 817,490 |
| | ----- |
| Total costs and operating expenses | 5,792,502 |
| | ----- |
| Operating income | 523,499 |
| Other expense (income): | |
| Gain on sale of investments | --- |
| Other expense (income) | (1,887) |
| | ----- |
| Total other expenses (income) | (1,887) |
| | ----- |
| Minority interests: | |
| Minority interest in subsidiaries income | 170,019 |
| Equity in loss (income) from unconsolidated subsidiary | 30,359 |
| | ----- |
| Total minority interest | 200,378 |

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| | |
|---|------------|
| Income before provision for income taxes | 325,008 |
| Provision for income taxes | 157,800 |
| Net income | \$ 167,208 |
| Net income per share: | |
| Basic | \$.04 |
| Diluted | \$.04 |
| Number of shares used in the computation of earnings per share: | |
| Basic | 3,954,553 |
| Diluted | 3,954,553 |

See accompanying notes.

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MEDSTONE INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

| | Common Stock | | Additional paid-in capital | Accumulated earnings | Accumulated Other Comprehensive income (loss) |
|---|---------------------|-----------|----------------------------------|-------------------------|--|
| | Number of shares | Amount | | | |
| Balance at December 31, 2001 | 4,111,220 | \$ 22,971 | \$19,646,388 | \$16,050,251 | \$ 32,756 |
| Net income | --- | --- | --- | 167,208 | --- |
| Other comprehensive income: | | | | | |
| Unrealized loss on foreign currency translation, net | --- | --- | --- | --- | (29,717) |
| Total comprehensive income | | | | | |
| Treasury stock repurchased | (180,000) | --- | --- | --- | --- |
| Balance at March 31, 2002 (Unaudited) | 3,931,220 | \$ 22,971 | \$19,646,388 | \$16,217,459 | \$ 3,039 |

See accompanying notes.

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MEDSTONE INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Three months ended March 31, 2002 and 2001
(Unaudited)

| | 2002 | 2001 |
|---|-------------|-------|
| | ----- | ----- |
| Cash flows from operating activities: | | |
| Net income | \$ 167,208 | \$ |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 433,876 | |
| Provision for doubtful accounts | 60,000 | |
| Provision for inventory obsolescence | 42,000 | |
| Gain on sale of long-term investments | --- | |
| Minority interest in partnerships | 170,019 | |
| Minority loss (equity) in unconsolidated subsidiary ... | 30,359 | |
| Changes in assets and liabilities: | | |
| Accounts receivable | 122,995 | |
| Inventories | 667,608 | |
| Prepaid expenses and other current assets | (37,721) | |
| Accounts payable and accrued expenses | (155,637) | |
| Accrued payroll expenses | (24,571) | |
| Accrued income taxes | --- | |
| Deferred revenue | 111,109 | |
| Customer deposits | (336,948) | |
| Other, net | (29,721) | |
| | ----- | ----- |
| Net cash provided by operating activities | 1,220,576 | 1, |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Purchase of short-term investments | (1,169,251) | (3, |
| Proceeds from sales of short-term investments | 1,139,288 | 4, |
| Proceeds from sale of long-term investments | --- | |
| Investment in sales type lease | (7,860) | |
| Distribution of minority interest | (188,000) | |
| Purchase of property and equipment, net | (635,514) | |
| | ----- | ----- |
| Net cash provided by investing activities | (861,337) | |
| | ----- | ----- |

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Cash flows from financing activities:

| | | |
|--|--------------|-------|
| Purchase of treasury stock | (819,750) | |
| Deferral of rent payments | 850 | |
| Loan payments | (3,985) | |
| | ----- | ----- |
| Net cash used in financing activities | (822,885) | |
| | ----- | ----- |
| Net increase (decrease) in cash and cash equivalents | (463,646) | 1, |
| Cash and equivalents at beginning of period | 1,928,731 | |
| | ----- | ----- |
| Cash and equivalents at end of period | \$ 1,465,085 | \$ 2, |
| | ===== | ===== |
| Supplemental cash flow disclosures: | | |
| Cash paid during the period for: | | |
| Income taxes | \$ 6,288 | \$ |
| | ===== | ===== |

See accompanying notes.

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MEDSTONE INTERNATIONAL, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2002

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 March 31, 2002 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 generally accepted accounting principles 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 2001 Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 1, 2002. Results of operations for the three months ended March 31, 2002 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 requires management to make assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

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B. Accumulated Other Comprehensive (Loss)/Income:

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

| | | Currency Translation Adjustment |
|--|----|---------------------------------------|
| Balance at December 31, 2001 | \$ | 32,756 |
| Foreign currency translation adjustments | | (29,717) |
| Balance at March 31, 2002 | \$ | 3,039 |

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

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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 March 31, 2002, total comprehensive income was \$137,491. For the three months ended March 31, 2001, total comprehensive income was \$346,270.

C. Business Segments

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

| | Three Months Ended | |
|---|--------------------|----------------|
| | March 31, 2002 | March 31, 2001 |
| | (Unaudited) | (Unaudited) |
| Revenue: | | |
| Equipment sales | \$ 1,896,443 | \$ 353,181 |
| Fees for procedures, maintenance fees and fee-for-service | 4,337,435 | 4,510,773 |
| | \$ 6,233,878 | \$ 4,863,954 |
| Operating income (loss): | | |
| Equipment sales | \$ (139,942) | \$ 9,366 |
| Fees for procedures, maintenance fees and fee-for-service | 663,441 | 357,548 |
| | \$ 523,499 | \$ 366,914 |

D. Per share information

The Company has adopted SFAS No. 128 "Earnings Per Share," and applied this

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pronouncement to all periods presented. This statement requires the presentation of both basic and diluted net income per share for financial statement purposes. 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.

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

| | Three Months Ended | |
|--|----------------------|----------------------|
| | March 31, 2002 | March 31, 2001 |
| | ----- (Unaudited) | ----- (Unaudited) |
| Numerator: Net income | \$ 167,208 | \$ 350,793 |
| | ===== | ===== |
| Denominator for weighted average shares outstanding | 3,954,553 | 4,273,220 |
| | ----- | ----- |
| Basic earnings per share | \$.04 | \$.08 |
| | ===== | ===== |
| Effect of dilutive securities: | | |
| Weighted average shares outstanding | 3,954,553 | 4,273,220 |
| Stock options | --- | 8,712 |
| | ----- | ----- |
| Denominator for diluted earnings per share | 3,954,553 | 4,281,932 |
| | ===== | ===== |
| Diluted earnings per share | \$.04 | \$.08 |
| | ===== | ===== |

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.

E. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following:

| | March 31, 2002 | December 31, 2001 |
|-----------------|----------------------|----------------------|
| | ----- (Unaudited) | ----- |
| Raw materials | \$ 3,852,940 | \$ 3,888,640 |
| Work in process | 520,823 | 231,175 |
| Finished goods | 1,052,957 | 1,983,236 |
| | ----- | ----- |
| | \$ 5,426,721 | \$ 6,103,051 |
| | ===== | ===== |

F. Contingencies

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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.

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G. Stock Repurchase Plan

In the first quarter of 2002 the Company purchased a total of 180,000 shares at an aggregate cost of \$819,750 under the Company's current Stock Repurchase Plan. To date under all of the Company's stock repurchase plans a total of 1,811,450 shares have been repurchased at a total cost of \$11,982,599.

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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 2001 Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 1, 2002.

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 first-in, first-out (FIFO) 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.

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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 continues to expand 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.

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As a manufacturer of medical devices, the Company has been vertically integrating by offering its medical devices directly to providers. It currently offers lithotripsy procedures using 15 mobile systems, two fixed sites and 22 transmobile lithotripters located throughout the United States on a per procedure basis. With the ability to offer quality equipment at reasonable prices, Medstone intends to continue the growth of this manufacturer direct business.

Three Months Ended March 31, 2002 Compared to Three Months Ended March 31, 2001

The Company recognized total revenue of \$6.3 million in the first quarter of 2002 compared to \$5.0 million in the first quarter of 2001, or a 26% increase. Revenues from procedures, maintenance and management fees decreased from \$4.5 million in the three months ended March 31, 2001 to \$4.3 million in the three months ended March 31, 2002 due to lower average per patient charges on the Company's fee-for-service equipment on a lower patient count. Also decreasing were the spares revenues as a lower number of shipments occurred in the current year compared to the same period of the prior year. Partially offsetting these decreases were increased maintenance revenues as the number of site under maintenance contracts increased in the current year when compared to the same period of the prior year. Equipment revenues increased to \$1.9 million in the quarter ending March 31, 2002 from \$.353 million in the comparable quarter of the prior year, or a 437% increase. The Company shipped three lithotripsy systems in the quarter ending March 31, 2002 compared to no systems in the each same period in the prior year. The Company also realized revenue on three UroPro urology systems in the current year with no comparable activity in the prior period due to the introduction of this product line in late 2001. The number of patient handling tables shipped in each period remained constant at 16 units, but the product mix changed and resulted in slightly lower revenue in the current year when compared to the prior year. Interest income decreased by 42% in the first quarter of 2002 when compared to the same period of the prior year due to a significant decline in investment yields and no significant change in the average invested balance.

Recurring revenue cost of sales decreased to 56% of sales in the

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quarter ended March 31, 2002 compared to 62% in the same quarter of the prior year. This is due to lower depreciation and equipment rental expenses as the fee-for-service revenue stream incorporates more fixed site fee-for-service units and older mobile vans are fully depreciated. Cost of sales on equipment sales decreased to 78% of sales in the three months ended March 31, 2002 compared to 99% of sales in the same period of 2001. This decrease is due to a significantly higher equipment sales activity with a negligible increase in costs of production. Overall cost of sales, as a percentage of revenue (excluding interest), decreased to 63% in the first quarter of 2002 compared to 65% in the first quarter of 2001.

Research and development costs remained constant at \$261,000 in the first quarter of 2001 when compared to the first quarter of 2001 due to decreased development costs for the UroPro offset by higher consulting expenses for the ultrasound application for the lithotripsy equipment.

Selling costs increased to \$812,000 in the first quarter of 2002 compared to \$531,000 in the same period of the prior year, a change of \$282,000 or 53% due to higher payroll expenses for added sales staff, increased bad debt expense and higher commission expenses.

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General and administrative expenses increased by \$153,000 or 23% in the three months ended March 31, 2002 compared to the same period in the prior year due to higher legal and consulting expenses.

Gain on sale of investments was \$0 in the quarter ending March 31, 2002 compared to \$350,000 in the three months ended March 31, 2001. The Company had no further sales of Cardiac Science, Inc. common stock in the current year, whereas the Company sold 73,000 shares of Cardiac Science in the same period of 2001. The net book value of the shares was \$0.

Total minority interest increased to \$200,000 in the three months ended March 31, 2002 compared to \$126,000 in the same period of the prior year due to lower profits in the Northern Nevada and Southern Idaho operations and recognition of the Company's portion of operating losses in Arcoma AB operations in 2002 compared to income from operations for Medicredit.com, Inc. in 2001.

Provision for income taxes for the first quarter of 2002 decreased by \$57,000 as a result of lower taxable income in the current year when compared to the same period of 2001.

Liquidity and Capital Resources

At March 31, 2002, the Company had cash and short-term investments of approximately \$6.1 million. These funds were generated from continuing operating activities.

As of March 31, 2002, the Company held 95,000 shares of Genstar Therapeutics Corp. common stock. The Company will continue to liquidate its holdings in these companies as markets allow.

As of May 1, 2002, the Company's holdings of Genstar Therapeutics Corp. (95,000 shares) has an approximate market value of \$74,000.

The Company's long-term capital expenditure requirements will depend on numerous factors, including the progress of the Company's research and

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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 2002.

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

Forward-looking statements in this report, including without limitation, statements relating to

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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.

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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

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None

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

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a) The following exhibits are included herein:

None.

(b) Reports on Form 8-K.

None.

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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 hereunto duly authorized.

MEDSTONE INTERNATIONAL, INC.

A Delaware corporation

Date: May 14, 2002

/s/ Mark Selawski

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

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