

MEDSTONE INTERNATIONAL INC/
Form 10-Q
November 14, 2003

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2003

or

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

For the transition period from _____ to _____

Commission file number **0-16752**

MEDSTONE INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

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DELAWARE
(State or other jurisdiction of
incorporation or organization)

66-0439440
(I.R.S. Employer
Identification No.)

100 Columbia, Suite 100, Aliso Viejo, California
(Address of principal executive offices)

92656
(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

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

Yes No

The number of shares of the Common Stock of the registrant outstanding as of November 10, 2003 was 3,758,220. The number of shares voting and non-voting Common Stock held by non-affiliates on such date was 3,664,512 with an approximate aggregate market value of \$14,548,112.

MEDSTONE INTERNATIONAL, INC.

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MEDSTONE INTERNATIONAL, INC.

CONSOLIDATED BALANCE SHEETS

| | September 30, 2003 | December 31, 2002 |
|--|-----------------------|----------------------|
| | (Unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 2,833,771 | \$ 2,050,466 |
| Short-term investments held to maturity | 4,392,063 | 4,323,491 |
| Accounts receivable, less allowance for doubtful accounts of \$1,022,821 and \$871,769 at September 30, 2003 and December 31, 2002, respectively | 3,615,485 | 3,720,410 |
| Income taxes receivable | | 589,375 |
| Inventories, less allowance for inventory obsolescence of \$866,700 and \$642,712 at September 30, 2003 and December 31, 2002, respectively | 6,317,036 | 6,440,304 |
| Deferred tax assets | 955,877 | 955,877 |
| Prepaid expenses and other current assets | 697,848 | 647,169 |
| | <u>18,812,080</u> | <u>18,727,092</u> |
| Buildings, property and equipment, at cost: | | |
| Building | 359,324 | 359,324 |
| Lithotripters | 13,562,890 | 13,524,440 |
| Equipment, furniture and fixtures | 3,454,566 | 3,368,431 |
| Leasehold improvements | 177,318 | 177,318 |
| | <u>17,554,098</u> | <u>17,429,513</u> |
| Less accumulated depreciation and amortization | (14,238,574) | (13,602,049) |
| | <u>3,315,524</u> | <u>3,827,464</u> |
| Net property and equipment | | |
| | <u>3,315,524</u> | <u>3,827,464</u> |
| Goodwill, net | 2,929,897 | 2,929,897 |
| Investment in unconsolidated subsidiaries | 885,962 | 734,083 |
| Net investment in sale-type lease | 509,840 | 169,428 |
| Other assets, net | 80,716 | 93,243 |
| | <u>26,534,019</u> | <u>26,481,207</u> |
| | <u>\$ 26,534,019</u> | <u>\$ 26,481,207</u> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 991,742 | \$ 900,295 |
| Accrued expenses | 206,279 | 267,229 |
| Accrued payroll expenses | 332,721 | 366,855 |
| Customer deposits | 127,514 | 75,175 |
| Deferred revenue | 596,156 | 494,704 |
| | <u>2,254,412</u> | <u>2,104,258</u> |
| Total current liabilities | | |
| | <u>2,254,412</u> | <u>2,104,258</u> |
| Deferred tax liabilities | 639,224 | 639,224 |
| Minority interest | 537,976 | 423,224 |
| Deferred rent | 70,119 | 82,613 |

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Commitments and contingencies (Note F)

Stockholders' equity:

| | | |
|--|----------------------|----------------------|
| Common stock - \$.004 par value, 20,000,000 shares authorized, 5,742,670 shares issued at both September 30, 2003 and December 31, 2002 | 22,971 | 22,971 |
| Additional paid-in capital | 19,646,388 | 19,646,388 |
| Accumulated earnings | 16,060,294 | 16,350,292 |
| Accumulated other comprehensive income (loss) | 68,344 | (22,054) |
| Treasury stock, at cost, 1,984,450 shares at both September 30, 2003 and December 31, 2002 | (12,765,709) | (12,765,709) |
| Total stockholders' equity | 23,032,288 | 23,231,888 |
| | \$ 26,534,019 | \$ 26,481,207 |

See accompanying notes

MEDSTONE INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

Three months ended September 30, 2003 and 2002

(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------|-------------------|---------------------|-------------------|
| | September 30, | | September 30, | |
| | 2003 | 2002 | 2003 | 2002 |
| Revenues: | | | | |
| Procedures, maintenance fees and fee-for service | \$ 4,342,363 | \$ 4,600,563 | \$ 12,409,571 | \$ 13,278,084 |
| Net equipment sales | 1,373,017 | 1,271,401 | 3,562,015 | 4,779,095 |
| Interest income | 38,978 | 84,862 | 117,431 | 246,506 |
| Total revenues | 5,754,358 | 5,956,826 | 16,089,017 | 18,303,685 |
| Costs and expenses: | | | | |
| Costs of procedures and maintenance fees | 2,329,620 | 2,604,139 | 7,100,598 | 7,642,548 |
| Cost of equipment sales | 1,195,626 | 837,740 | 3,024,920 | 3,506,676 |
| Research and development | 457,621 | 360,304 | 1,362,585 | 935,214 |
| Selling | 627,342 | 702,431 | 2,030,363 | 2,308,676 |
| General and administrative | 869,301 | 708,839 | 2,402,225 | 2,360,060 |
| Total costs and operating expenses | 5,479,510 | 5,213,453 | 15,920,691 | 16,753,174 |
| Operating income | 274,848 | 743,373 | 168,326 | 1,550,511 |
| Other expense (income) | 19,389 | 22,942 | 41,751 | 25,208 |
| Minority interests: | | | | |
| Minority interest in subsidiaries income | 223,116 | 191,550 | 572,752 | 522,208 |
| Equity in loss (income) from unconsolidated subsidiary | 64,396 | | (160,379) | 30,359 |
| Total minority interest | 287,512 | 191,550 | 412,373 | 552,439 |
| Income (loss) before provision for income taxes | (32,053) | 528,881 | (285,798) | 972,864 |
| Provision for income taxes | 74,100 | 301,800 | 4,200 | 497,300 |
| Net income (loss) | \$ (106,153) | \$ 227,081 | \$ (289,998) | \$ 475,564 |
| Net income (loss) per share: | | | | |
| Basic | \$ (.03) | \$.06 | \$ (.08) | \$.12 |
| Diluted | N/A | \$.06 | N/A | \$.12 |
| Number of shares used in the computation of earnings (loss) per share: | | | | |
| Basic | 3,758,220 | 3,812,153 | 3,758,220 | 3,896,819 |
| Diluted | N/A | 3,812,153 | N/A | 3,896,850 |



See accompanying notes.

MEDSTONE INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

| | Common Stock | | Additional paid-in capital | Accumulated earnings | Accumulated Other Comprehensive income (loss) | Treasury Stock | Total |
|---|---------------------|-----------|----------------------------------|-------------------------|--|-------------------|---------------|
| | Number of shares | Amount | | | | | |
| Balance at December 31, 2002 | 3,758,220 | \$ 22,971 | \$ 19,646,388 | \$ 16,350,292 | \$ (22,054) | \$ (12,765,709) | \$ 23,231,888 |
| Net loss | | | | (289,998) | | | (289,998) |
| Other comprehensive income: | | | | | | | |
| Unrealized gain on foreign currency translation, net | | | | | 90,398 | | 90,398 |
| Total comprehensive loss | | | | | | | (199,600) |
| Balance at September 30, 2003 (Unaudited) | 3,758,220 | \$ 22,971 | \$ 19,646,388 | \$ 16,060,294 | \$ 68,344 | \$ (12,765,709) | \$ 23,032,288 |

See accompanying notes.

MEDSTONE INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Nine months ended September 30, 2003 and 2002

(Unaudited)

| | <u>2003</u> | <u>2002</u> |
|--|--------------------|--------------------|
| Cash flows from operating activities: | | |
| Net income (loss) | \$ (289,998) | \$ 475,564 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,189,042 | 1,356,731 |
| Provision for doubtful accounts | 165,000 | 165,000 |
| Provision for inventory obsolescence | 225,000 | 126,000 |
| Minority interest in partnership | 572,752 | 522,080 |
| Minority equity in unconsolidated subsidiaries | (151,879) | 30,359 |
| Changes in assets and liabilities: | | |
| Accounts receivable | 188,888 | 28,253 |
| Inventories | (101,732) | (54,499) |
| Prepaid expenses and other current assets | (50,679) | 242,471 |
| Accounts payable and accrued expenses | 30,497 | (37,553) |
| Accrued payroll expenses | (34,134) | 122,124 |
| Accrued income taxes | | 211,102 |
| Deferred revenue | 101,452 | (104,212) |
| Customer deposits | 52,339 | (283,136) |
| Other, net | 180,253 | (37,747) |
| | <u>2,076,801</u> | <u>2,762,537</u> |
| Cash flows from investing activities: | | |
| Purchase of short-term investments | (4,392,063) | (4,305,503) |
| Proceeds from sales of short-term investments | 4,323,491 | 4,570,420 |
| Net investment in sales type lease | | (133,564) |
| Distribution of minority interest | (458,000) | (550,000) |
| Investment in other entities | | |
| Purchase of property and equipment, net | (754,430) | (930,103) |
| | <u>(1,281,002)</u> | <u>(1,348,750)</u> |
| Cash flows from financing activities: | | |
| Purchase of treasury stock | | (1,602,860) |
| Deferral of rent payments | (12,494) | (334) |
| | <u>(12,494)</u> | <u>(1,603,194)</u> |
| Net cash used in financing activities | (12,494) | (1,603,194) |
| Net increase in cash and cash equivalents | 783,305 | (189,407) |
| Cash and cash equivalents at beginning of period | 2,050,466 | 1,928,731 |
| | <u>2,833,771</u> | <u>1,739,324</u> |
| Cash and cash equivalents at end of period | \$ 2,833,771 | \$ 1,739,324 |

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Supplemental cash flow disclosures:

Cash paid during the period for:

| | | |
|--------------|-----------|------------|
| Income taxes | \$ 27,488 | \$ 331,008 |
|--------------|-----------|------------|

See accompanying notes.

MEDSTONE INTERNATIONAL, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2003

A. Basis of presentation

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

In the opinion of the Company's management, the accompanying unaudited condensed consolidated financial statements include all adjustments (which consist only of normal recurring adjustments) necessary for a fair presentation of its consolidated financial position at September 30, 2003 and consolidated results of operations and cash flows for the periods presented. Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These financial statements should be read in conjunction with the Company's audited financial statements included in the Company's 2002 Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 1, 2003. Results of operations for the three and nine months ended September 30, 2003 are not necessarily indicative of results to be expected for the full year.

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

B. Accumulated Other Comprehensive Loss

The components of other comprehensive loss are as follows:

| | Currency Translation Adjustment |
|--|--|
| Balance at December 31, 2002 | \$ (22,054) |
| Foreign currency translation adjustments | 90,398 |
| Balance at September 30, 2003 | <u>\$ 68,344</u> |

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

MEDSTONE INTERNATIONAL, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 September 30, 2003 and 2002, total comprehensive income/(loss) was \$(32,456) and \$201,779, respectively. For the nine months ended September 30, 2003 and 2002, total comprehensive income/(loss) was \$(199,600) and \$404,872, respectively.

C. Business Segments

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

| | Three months ended | | Nine months ended | |
|---|---------------------|---------------------|----------------------|----------------------|
| | September | | September | |
| | 2003 | 2002 | 2003 | 2002 |
| Revenue: | | | | |
| Equipment sales | \$ 1,373,017 | \$ 1,271,401 | \$ 3,562,015 | \$ 4,779,095 |
| Fees for procedures, maintenance and management | 4,342,363 | 4,600,563 | 12,409,571 | 13,278,084 |
| | <u>\$ 5,715,380</u> | <u>\$ 5,871,964</u> | <u>\$ 15,971,586</u> | <u>\$ 18,057,179</u> |
| Operating income (loss): | | | | |
| Equipment sales | \$ (166,049) | \$ 131,187 | \$ (620,376) | \$ 241,918 |
| Fees for procedures, maintenance and management | 440,897 | 612,186 | 788,702 | 1,308,593 |
| | <u>\$ 274,848</u> | <u>\$ 743,373</u> | <u>\$ 168,326</u> | <u>\$ 1,550,511</u> |

D. Per share information

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.

MEDSTONE INTERNATIONAL, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|------------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2003 | 2002 | 2003 | 2002 |
| Numerator: Net income (loss) | \$ (106,153) | \$ 227,081 | \$ (289,998) | \$ 475,564 |
| Denominator for weighted average shares outstanding | 3,758,220 | 3,812,153 | 3,758,220 | 3,896,819 |
| Basic income (loss) per share | \$ (.03) | \$.06 | \$ (.08) | \$.12 |
| Effect of dilutive securities: | | | | |
| Weighted average shares outstanding | N/A | 3,812,153 | N/A | 3,896,819 |
| Stock options | N/A | | N/A | 31 |
| Denominator for diluted earnings per share | N/A | 3,812,153 | N/A | 3,896.850 |
| Diluted earnings per share | N/A | \$.06 | N/A | \$.12 |

E. Inventories

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

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

| | September 30, 2003 | December 31, 2002 |
|-------------------|-----------------------|----------------------|
| Raw materials | \$ 5,376,576 | \$ 5,231,574 |
| Work in process | 196,374 | 312,665 |
| Finished goods | 1,610,786 | 1,538,777 |
| Gross Inventories | \$ 7,183,736 | \$ 7,083,016 |

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| | | |
|--------------------------|---------------------|---------------------|
| Less: Inventory reserves | <u>(866,700)</u> | <u>(642,712)</u> |
| Net inventories | <u>\$ 6,317,036</u> | <u>\$ 6,440,304</u> |

F. Contingencies

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

MEDSTONE INTERNATIONAL, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

G. Stock Compensation

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

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

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

| | Three Months ended | | Nine Months ended | |
|----------------------------------|--------------------|-------------------|-------------------|-------------------|
| | Sept. 30, 2003 | Sept. 30, 2002 | Sept. 30, 2003 | Sept. 30, 2002 |
| Net income (loss): | | | | |
| As reported | \$ (106) | \$ 227 | \$ (290) | \$ 476 |
| Compensation expense, net of tax | 32 | 52 | 107 | 162 |
| Pro forma | \$ (138) | \$ 175 | \$ (397) | \$ 314 |
| Earnings per share: | | | | |
| Basic | \$ (.03) | \$.06 | \$ (.08) | \$.12 |
| Diluted | N/A | \$.06 | N/A | \$.12 |
| Pro forma basic | \$ (.04) | \$.05 | \$ (.11) | \$.08 |
| Pro forma diluted | N/A | \$.05 | N/A | \$.08 |

H. Subsequent Event

On November 11, 2003, the Company, Prime Medical Services, Inc., a Delaware corporation (*Prime*), and a wholly-owned subsidiary of Prime entered into an Agreement and Plan of Merger (the *Merger Agreement*). Pursuant to the Merger Agreement and subject to the terms and

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conditions set forth therein, the subsidiary will be merged into Medstone and, as the surviving corporation, Medstone will become a wholly-owned subsidiary of Prime (the Merger). As a result of the Merger, Medstone shareholders will receive \$5.00 of Prime common stock for each share of Medstone common stock they hold, subject to cash payments for fractional shares. The number of Prime shares to be issued to Medstone shareholders will be calculated based on the average closing price of Prime common stock for the 30 trading days immediately preceding the third trading day before the closing of the transaction. The completion of the Merger is subject to approval by the shareholders of Medstone and of Prime and other conditions set forth in the Merger Agreement. The Merger is intended to be a tax-free reorganization under Section 368(a) of the Internal Revenue Code, as amended. The details of this transaction are disclosed in the Merger Agreement in the Company's Form 8-K filed with the Securities and Exchange Commission on November 12, 2003.

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

The following discussion and analysis should be read in conjunction with the Company's audited financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's 2002 Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 1, 2003.

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

The average cost method to value a majority of our inventories; and

The intrinsic value method, or APB Opinion No. 25, to account for our common stock incentive awards; and

We record an allowance for credit losses based on estimates of customers' ability to pay. If the financial condition of our customers were to deteriorate, additional allowances may be required.

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

Results of Consolidated Operations

General

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

As a manufacturer of medical devices, the Company is vertically integrated by offering its medical devices directly to providers. It currently offers lithotripsy procedures using 14 mobile systems, one fixed site and 25 transmobile lithotripters located throughout the United States on a per procedure basis. With the ability to offer state-of-the-art equipment at reasonable prices, Medstone continues to consider this part of its business as an integral part of its business plan.

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

The Company recognized total revenue of \$5.75 million in the third quarter of 2003 compared to \$5.96 million in the third quarter of 2002, or a 3% decrease. Revenues from procedures, maintenance and management fees decreased to \$4.34 million in the three months ended September 30, 2003 compared to \$4.60 million in the three months ended September 30, 2002 due to lower overall average per patient charges on both the Company's fee-for-service equipment and the procedure fees on essentially unchanged patient volume. Equipment revenues increased to \$1.37 million in the quarter ending September 30, 2003 from \$1.27 million in the comparable quarter of the prior year, or an 8% increase due primarily due to equipment mix. The Company shipped three lithotripsy systems in the three months ended September 30, 2003 compared to two lithotripsy systems and one UroPro urology system in the same period of 2002. The number of various patient handling tables shipped in the third quarter of each year remained constant.

Interest income decreased by 54% in the third quarter of 2003 when compared to the same period of the prior year due to a continued record-low investment yields and a decrease of approximately \$ 1.56 million in the average invested balance. The Company considered the \$2.0 million note receivable from Medcredit in 2002 as invested balance, although it had been fully reserved.

Recurring revenue cost of sales decreased to 54% of sales in the quarter ended September 30, 2003 compared to 57% in the same quarter of the prior year. This is due to lower depreciation associated with the Company's in-service fleet of fee-for-service lithotripters and lower material costs in fulfillment of maintenance contracts.

Cost of sales on equipment sales increased to 87% of sales in the three months ended September 30, 2003 compared to 66% of sales in the same period of 2002. This increase is due to higher overhead as the Company has incurred additional expenses to meet shipment schedules. Also, lithotripsy equipment cost of sales increased due to additional features which have been added while average sales prices decreased slightly. Overall cost of sales, as a percentage of revenue (excluding interest), increased to 62% in the third quarter of 2003 compared to 59% in the third quarter of 2002.

Research and development costs increased to \$458,000 in the third quarter of 2003 compared to \$360,000 in the third quarter of 2002 or an increase of 27% due to continued consulting and material costs associated with the development of the UroPro Vista urology table and the MultiRad imaging system. The Company expects completion of a beta site unit of the MultiRad by year end and completion of the first customer unit of the UroPro Vista in early 2004.

Selling costs decreased to \$627,000 in the third quarter of 2003 compared to \$702,000 in the same period of the prior year, a decrease of \$75,000 or 11% due to lower consulting expenses in 2003 due to a streamlined effort in the gallstone marketing effort when compared to 2002.

General and administrative expenses increased by \$160,000 or 23% in the three months ended September 30, 2003 compared to the same period in the prior year due to higher expenses for advisors and consultants for the Company's work on the evaluation and preparation of the merger agreement with Prime Medical Systems.

Total minority interest expense increased to \$288,000 in the three months ended September 30, 2003 compared to \$192,000 in the same period of the prior year. This increase was due to the recognition of the Company's portion of Arcoma's quarter losses and higher minority share of profits in Northern Nevada operations in the current quarter due to restructured service pricing.

Provision for income taxes for the third quarter of 2003 decreased by \$228,000 compared to the same period of 2002 as a result of lower domestic taxable income in the current year.

Nine Months Ended September 30, 2003 Compared to Nine Months Ended September 30, 2002

The Company recorded total revenue of \$16.09 million in the first nine months of 2003 or a 12% decrease compared to \$18.30 million in the corresponding period of 2002. Revenues from procedures, maintenance and management fees decreased by \$869,000, or 6%, due to lower average reimbursement per patient and total patient count in both the Company owned and third party procedures. Equipment revenue also decreased by \$1,217,000, or 26%, as lithotripter shipments decreased from 8 in the nine months ended September 30, 2002 to 5 in the same period of 2003. Also decreasing was revenue related to the UroPro urology table, with five units shipped in the nine months ended September 30, 2002 and two units shipped in the comparable period of 2003. Partially offsetting these decreases, the activity in the various patient handling tables in the first nine months of 2003 increased to 95 units compared to 68 units in the same period of 2002.

Interest income decreased by 52% for the first nine months of 2003 when compared to the same period of the prior year as interest yields have remained at historic lows during the first nine months of 2003 and the average invested balance was \$1.7 million lower when compared to the same period of 2002. The Company considered the \$2.0 million note receivable from Medicredit in 2002 as invested balance, although it had been fully reserved.

Procedure, maintenance and management fee cost of sales decreased to 57% in the nine months ended September 30, 2003 compared to 58% in the same period of the prior year as costs decreased in the fee-for-service program due to a shift in equipment placements and the related lower depreciation and equipment rental costs.

Cost of sales on equipment sales increased to 85% of revenue in the first nine months of 2003 compared to 73% of revenue in the first nine months of 2002 due to higher expenses to meet shipment dates even as the total number of units for lithotripsy and urology tables decreased. Overall cost of sales, as a percentage of revenue (excluding interest), increased slightly to 63% in the first nine months of 2003 compared to 62% in the first nine months of 2002.

Research and development costs increased by \$427,000, or 46% in the first nine months of 2003 when compared to the same period of 2002 due to the Company's development costs associated with the UroPro Vista urology table and the MultiRad imaging system. Both projects have had ongoing expenses for the full nine month period of 2003.

Selling costs decreased by 12%, or \$278,000, in the first nine months of 2003 compared to the same period of 2002 due to lower commissionable revenue and lower consulting due to the re-adjustment of the gallstone marketing efforts.

Minority interest decreased by 25% in the nine months ended September 30, 2003 when compared to the same period of the prior year due to recognition of the Company's portion of Arcoma's profits, partially offset by higher minority share of profits in the Northern Nevada operations due to restructured service pricing.

Liquidity and Capital Resources

At September 30, 2003, the Company had cash and short-term investments of approximately \$7.2 million. These funds were generated from continuing operating activities.

As of September 30, 2003, the Company held 13,571 shares of CorAutus Genetics, Inc. common stock, with an approximate market value of \$77,898. The Company will continue to liquidate its holdings in this Company as markets allow.

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

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

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

Forward-looking statements in this report, including without limitation, statements relating to the Company's plans, strategies, objectives, expectations, intentions and adequacy of resources, are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Investors are cautioned that such forward-looking statements involve risks and uncertainties including without limitation the following: (i) the Company's plans, strategies, objections, expectations and intentions are subject to change at any time at the discretion of the Company, (ii) the Company's plans and results of operations will be affected by the Company's ability to manage its growth; (iii) the Company's businesses are highly competitive and the entrance of new competitors into or the expansion of the operations by existing competitors in the Company's markets and other changes could adversely affect the Company's plans and results of operations; and (iv) other risks and uncertainties indicated from time to time in the Company's filings with the Securities and Exchange Commission.

Item 3. Market Risk Changes

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

Item 4. Controls and Procedures

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

MEDSTONE INTERNATIONAL, INC.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 2. Changes in Securities

None

Item 3. Defaults upon Senior Securities

None

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

See Item 4 of Part II of the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a) The following exhibits are included herein:

- 2.1 Agreement and Plan of Merger dated as of November 11, 2003 among the Company, Prime Medical Services, Inc., a Delaware corporation ("Prime"), and a wholly-owned subsidiary of Prime, previously filed with the same exhibit number with the Company's Current Report on Form 8-K filed on November 12, 2003 and incorporated herein by reference.
- 2.2 Voting Agreement dated as of November 11, 2003 among the Company, Prime and David V. Radlinski, previously filed with the same exhibit number with the Company's Current Report on Form 8-K filed on November 12, 2003 and incorporated herein by reference.
- 3.1 Certificate of Incorporation of the Company, as amended, previously filed with the same exhibit number with the Company's Registration Statement on Form S-1 under the Securities Act of 1933, Reg. No. 33-16340, with

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the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1988, with the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 1991 and with the Company's Quarterly Report for the quarter ended September 30, 1995, all incorporated herein by reference.

- 10.30 Amendment to Employment Agreement with David Radlinski
- 10.31 Amendment to Employment Agreement with Mark Selawski
- 10.32 Amendment to Employment Agreement with Eva Novotny
- 31.1 Certificate of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 dated November 12, 2003.
- 31.2 Certificate of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 dated November 12, 2003.
- 32 Certificate of Chief Executive Officer and Chief Financial Officer pursuant to section 18 U.S.C. section 1350 dated November 12, 2003.

(b) Reports on Form 8-K.

On August 13, 2003, we filed a Current Report on Form 8-K with the Securities and Exchange Commission, reporting under *Item 9. Regulation FD Disclosure* (furnished under *Item 12. Results of Operations and Financial Condition*) our operating results for the quarter ended June 30, 2003.

SIGNATURES

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

Medstone International, Inc.

A Delaware corporation

Date: November 12, 2003

By:

/s/ MARK SELAWSKI

Mark Selawski

Chief Financial Officer

(Principal financial and accounting officer)

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