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MEDSTONE INTERNATIONAL INC/
Form 10-Q
August 10, 2001

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2001

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

92656-4114

(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
August 7, 2001 was 4,198,220.

MEDSTONE INTERNATIONAL, INC.

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MEDSTONE INTERNATIONAL, INC. CONSOLIDATED BALANCE SHEETS

| | | June 30, 2001 ----- (Unaudited) |
|--|----|--|
| ASSETS ----- | | |
| Current assets: | | |
| Cash and cash equivalents | \$ | 1,737,196 |
| Short-term investments held to maturity | | 4,485,899 |
| Accounts receivable, less allowance for doubtful accounts of \$581,487 at June 30, 2001 and \$477,180 at December 31, 2000, respectively | | 4,250,534 |
| Inventories, less allowance for inventory obsolescence | | |

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| | |
|---|---------------|
| of \$456,417 at June 30, 2001 and \$457,088 at December 31, 2000, respectively | 6,129,723 |
| Deferred tax assets | 1,005,814 |
| Prepaid expenses and other current assets | 518,747 |
| | ----- |
| Total current assets | 18,127,913 |
| | |
| Buildings, property and equipment, at cost: | |
| Building | 359,324 |
| Lithotrippers | 12,977,158 |
| Equipment, furniture and fixtures | 2,940,931 |
| Leasehold improvements | 162,883 |
| | ----- |
| | 16,440,296 |
| Less accumulated depreciation and amortization | (11,460,788) |
| | ----- |
| Net property and equipment | 4,979,508 |
| | ----- |
| | |
| Goodwill, net | 3,257,047 |
| Investment in unconsolidated subsidiaries | 1,300,763 |
| Long-term receivable from unconsolidated subsidiary | 2,000,000 |
| Other assets, net | 129,952 |
| | ----- |
| | \$ 29,795,183 |
| | ===== |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | |
|--|---------------|
| ----- | |
| Current liabilities: | |
| Accounts payable | \$ 577,804 |
| Accrued expenses | 513,849 |
| Accrued income taxes | 117,627 |
| Accrued payroll expenses | 270,392 |
| Customer deposits | 366,808 |
| Deferred revenue | 536,473 |
| | ----- |
| Total current liabilities | 2,382,953 |
| | |
| Deferred tax liabilities | 562,313 |
| Minority interest | 541,251 |
| Deferred rent | 84,106 |
| Stockholders' equity: | |
| Common stock - \$.004 par value, 20,000,000 shares authorized, 5,742,670 shares issued and outstanding at both June 30, 2001 and December 31, 2000, respectively | 22,971 |
| Additional paid-in capital | 19,646,388 |
| Accumulated earnings | 17,288,717 |
| Accumulated other comprehensive income | 41,573 |
| Treasury stock, at cost, 1,544,450 and 1,434,450 shares at June 30, 2001 and December 31, 2000, respectively | (10,775,089) |
| | ----- |
| Total stockholders' equity | 26,224,560 |
| | ----- |
| | \$ 29,795,183 |
| | ===== |

See accompanying notes.

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three Months Ended June 30, | | S |
|--|--------------------------------|-------------|--------|
| | 2001 | 2000 | 20 |
| | ----- | ----- | ----- |
| Revenues: | | | |
| Procedures, maintenance fees and fee-for service | \$4,719,194 | \$4,656,903 | \$ 9,2 |
| Net equipment sales | 744,678 | 1,177,500 | 1,0 |
| Interest income | 116,071 | 148,702 | 2 |
| | ----- | ----- | ----- |
| Total revenues | 5,579,943 | 5,983,105 | 10,5 |
| Costs and expenses: | | | |
| Costs of procedures and maintenance fees | 2,677,076 | 2,685,084 | 5,5 |
| Cost of equipment sales | 671,539 | 843,230 | 1,0 |
| Research and development | 299,147 | 403,324 | 5 |
| Selling | 713,029 | 496,386 | 1,2 |
| General and administrative | 648,276 | 658,554 | 1,3 |
| | ----- | ----- | ----- |
| Total costs and operating expenses | 5,009,067 | 5,086,578 | 9,6 |
| | ----- | ----- | ----- |
| Operating income | 570,876 | 896,527 | 9 |
| Other expense (income): | | | |
| Gain on sale of investments | (69,497) | (298,154) | (4 |
| Other expense | 19,033 | 41,155 | |
| | ----- | ----- | ----- |
| Total other expenses (income) | (50,464) | (256,999) | (3 |
| | ----- | ----- | ----- |
| Minority interests: | | | |
| Minority interest in subsidiaries income | 179,564 | 208,548 | 3 |
| Equity in income from unconsolidated subsidiary | (7,656) | --- | (|
| | ----- | ----- | ----- |
| Total minority interest | 171,908 | 208,548 | 2 |
| | ----- | ----- | ----- |
| Income before provision for income taxes | 449,432 | 944,978 | 1,0 |
| Provision for income taxes | 219,651 | 389,990 | 4 |
| | ----- | ----- | ----- |
| Net income | \$ 229,781 | \$ 554,988 | \$ 5 |
| | ===== | ===== | ===== |
| Earnings per share | | | |
| Basic | \$.05 | \$.12 | \$ |
| | ===== | ===== | ===== |
| Diluted | \$.05 | \$.12 | \$ |
| | ===== | ===== | ===== |
| Number of shares used in the computation of earnings per share: | | | |
| Basic | 4,198,220 | 4,590,025 | 4,2 |
| | ===== | ===== | ===== |
| Diluted | 4,198,609 | 4,591,319 | 4,2 |
| | ===== | ===== | ===== |

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See accompanying notes.

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MEDSTONE INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

| | Common Stock | | Additional paid-in capital | Accumulated earnings | Accumulat Other Comprehen income (1 |
|---|---------------------|-----------|----------------------------------|-------------------------|--|
| | Number of shares | Amount | | | |
| Balance at December 31, 2000 | 4,308,220 | \$ 22,971 | \$ 19,646,388 | \$ 16,708,143 | \$ 55 |
| Net income | --- | --- | --- | 580,574 | |
| Other comprehensive income: | | | | | |
| Unrealized loss on foreign currency translation, net | --- | --- | --- | --- | (13 |
| Total comprehensive income | | | | | |
| Treasury stock repurchased | (110,000) | --- | --- | --- | |
| Balance at June 30, 2001 (Unaudited) | 4,198,220 | \$ 22,971 | \$ 19,646,388 | \$ 17,288,717 | \$ 41 |

See accompanying notes.

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MEDSTONE INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Six months ended June 30, 2001 and 2000

(Unaudited)

| | 2001 | 2000 |
|--|------------|--------------|
| Cash flows from operating activities: | | |
| Net income | \$ 580,574 | \$ 1,477,265 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,080,129 | 1,204,978 |
| Provision for doubtful accounts | 110,000 | --- |
| Provision for inventory obsolescence | 84,000 | 40,000 |
| Gain on sale of long-term investments | (427,605) | (1,080,710) |
| Minority interest in partnerships | 334,959 | 400,007 |
| Minority equity in unconsolidated subsidiary | (37,165) | --- |
| Changes in assets and liabilities: | | |

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| | | |
|---|--------------|--------------|
| Accounts receivable | (194,971) | (1,322,466) |
| Inventories | (110,672) | (406,442) |
| Prepaid expenses and other current assets | 8,078 | 20,149 |
| Accounts payable and accrued expenses | (137,826) | 162,194 |
| Accrued payroll expenses | (76,642) | 42,764 |
| Accrued income taxes | 72,028 | 76,321 |
| Deferred revenue | (119,859) | (5,525) |
| Customer deposits | 308,367 | 5,900 |
| | ----- | ----- |
| Other, net | (15,308) | 105,822 |
| | ----- | ----- |
| Net cash provided by operating activities | 1,458,087 | 720,257 |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Purchase of short-term investments | (5,602,921) | (7,767,338) |
| Proceeds from sales of short-term investments | 6,340,681 | 8,629,990 |
| Investment in other entities | --- | (1,000,000) |
| Proceeds from sale of long-term investments | 427,605 | 1,080,710 |
| Distribution of minority interest | (348,000) | (272,000) |
| Purchase of property and equipment, net | (830,138) | (497,485) |
| | ----- | ----- |
| Net cash provided by (used in) investing activities | (12,773) | 173,877 |
| | ----- | ----- |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock | --- | 5,190 |
| Proceeds of treasury stock | (650,506) | (729,976) |
| Deferral of rent payments | 5,409 | --- |
| Loan payments | (8,631) | (17,988) |
| | ----- | ----- |
| Net cash used in financing activities | (653,728) | (742,774) |
| | ----- | ----- |
| Net increase in cash and equivalents | 791,586 | 151,360 |
| Cash and equivalents at beginning of period | 945,610 | 1,061,422 |
| | ----- | ----- |
| Cash and equivalents at end of period | \$ 1,737,196 | \$ 1,212,782 |
| | ===== | ===== |
| Supplemental cash flow disclosures: | | |
| Cash paid during the period for: | | |
| Income taxes | \$ 396,452 | \$ 945,926 |

See accompanying notes.

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MEDSTONE INTERNATIONAL, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2001

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.

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In the opinion of the Company's management, the accompanying unaudited condensed consolidated financial statements include all adjustments (which consist only of normal recurring adjustments) necessary for a fair presentation of its consolidated financial position at June 30, 2001 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 2000 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2001. Results of operations for the three and six months ended June 30, 2001 are not necessarily indicative of results to be expected for the full year.

The preparation of financial statements in accordance with generally accepted accounting principles 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. Recently Issued Accounting Pronouncement

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.

The Company will apply the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of 2002. Application of the nonamortization provisions of the Statement is expected to result in an increase in net income, after tax, of approximately \$60,000 (\$.01 per share) per year. During 2002, the Company will perform the first of the required impairment tests of goodwill and indefinite lived intangible assets as of January 1, 2002 and has not yet determined what the effect of these tests will be on the earnings and financial position of the Company.

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C. Accumulated Other Comprehensive Loss

The components of other comprehensive loss are as follows:

| | Currency Translation Adjustment ----- |
|--|--|
| Balance at December 31, 2000 | \$55,395 |
| Foreign currency translation adjustments | (13,822) |
| | ----- |
| Balance at June 30, 2001 | \$41,573 ===== |

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 June 30, 2001 and 2000, total comprehensive income was \$220,482 and \$606,042, respectively, For the six months ended June 30, 2001 and 2000, total comprehensive income was \$566,752 and \$1,588,522, respectively.

D. Business Segments

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

| | Three months ended | | Six months ended | |
|---|--------------------|---------------|------------------|---------------|
| | June 30, 2001 | June 30, 2000 | June 30, 2001 | June 30, 2000 |
| Revenue: | | | | |
| Equipment sales | \$ 744,678 | \$ 1,177,500 | \$ 1,097,859 | \$ 2,506,544 |
| Fees for procedures, maintenance and management | 4,719,194 | 4,656,903 | 9,229,967 | 9,307,221 |
| | \$5,463,872 | \$ 5,834,403 | \$10,327,826 | \$11,813,765 |
| | ===== | ===== | ===== | ===== |
| Operating income (loss): | | | | |
| Equipment sales | (35,918) | \$ 113,757 | \$ (123,691) | \$ 222,070 |
| Fees for procedures, maintenance and management | 606,794 | 1,039,769 | 1,061,481 | 2,675,192 |
| | \$570,876 | \$1,153,526 | \$ 937,790 | \$ 2,897,262 |
| | ===== | ===== | ===== | ===== |

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E. Per share information

The Company has adopted SFAS No. 128 "Earnings Per Share," and applied this 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. All earnings per share amounts for all periods have been restated to conform with the SFAS No. 128 requirements and the accounting rules set forth in Staff Accounting Bulletin 98 issued by the Securities and Exchange Commission on February 3, 1998.

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

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| | Three Months Ended June 30, | | Six Months E |
|---|-----------------------------|------------|--------------|
| | 2001 | 2000 | 2001 |
| Numerator: Net income | \$ 229,781 | \$ 554,988 | \$ 580,574 |
| Denominator for weighted average shares outstanding | 4,198,220 | 4,590,025 | 4,235,720 |
| Basic earnings per share | \$.05 | \$.12 | \$.14 |
| Effect of dilutive securities: | | | |
| Weighted average shares outstanding | 4,198,220 | 4,590,025 | 4,235,720 |
| Stock options | 389 | 1,294 | 5,008 |
| Denominator for diluted earnings per share | 4,198,609 | 4,591,319 | 4,240,728 |
| Diluted earnings per share | \$.05 | \$.12 | \$.14 |

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.

F. Inventories

At June 30, 2001 and December 31, 2000, inventories consisted of the following:

| | June 31, 2001 | December 31, 2000 |
|-----------------|------------------|----------------------|
| Raw materials | \$4,656,119 | \$3,888,640 |
| Work in process | 239,034 | 231,175 |
| Finished goods | 1,234,570 | 1,983,236 |
| | \$6,129,723 | \$6,103,051 |

G. 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 condensed consolidated financial statements.

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H. Stock Repurchase Plan

In the second quarter of 2001 the Company purchased a total of 25,000 shares at an aggregate cost of \$144,469, completing the Company's latest Stock Repurchase Plan. Under all of the Company's stock repurchase plans a total of 1,544,450 shares have been repurchased at a total cost of \$10,775,089.

I. Subsequent Events

Sale of Cardiac Science Stock -----

Subsequent to June 30, 2001, the Company sold 60,700 shares of its holdings of Cardiac Science, Inc., for gross proceeds of approximately \$149,000 in cash. The Company still holds 25,300 shares of Cardiac Science, Inc.

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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 2000 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2001.

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 are 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 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 23 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.

Results of Operations

Three Months ended June 30, 2001 Compared to Three Months Ended June 30, 2000

The Company recognized total revenue of \$5.6 million in the second quarter of 2001 compared to \$6.0 million in the second quarter of 2000, or a 7% decrease. Revenues from procedures, maintenance and management fees increased from \$4.656 million in the three months ended June 30, 2000 to \$4.719 million in the three months ended June 30, 2001 due to higher patient counts on the Company's fee-for-service equipment although average per patient reimbursement

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declined. The revenues for radiology and spares activity also increased in the current quarter compared to the same period in the prior year. Offsetting these increases were declines in the third party procedure fee as volume remained steady but per patient reimbursement declined. Equipment revenues decreased to \$0.7 million in the quarter ended June 30, 2001 from \$1.2 million in the comparable quarter of the prior year, or a 37% decrease, as the Company shipped two lithotripsy systems and 1 radiology suite in the U.K. in 2000 versus 1 litho system and 31 various imaging tables in the quarter ended June 30, 2001.

Interest income decreased by 22% in the second quarter of 2001 when compared to the same period of the prior year due to a significant decline in investment yields and a decreased average

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invested balance.

Recurring revenue cost of sales decreased to 57% of sales in the quarter ended June 30, 2001 compared to 58% 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 increased to 90% of sales in the three months ended June 30, 2001 compared to 72% of sales in the same period of 2000. This increase is due to a higher cost of sales of imaging tables and increased costs of production on lithotripsy equipment. Overall cost of sales, as a percentage of revenue (excluding interest), increased to 61% in the second quarter of 2001 compared to 60% in the second quarter of 1999.

Research and development costs decreased to \$299,000 in the second quarter of 2001 compared to \$403,000 in the second quarter of 2000 or a decrease of 26% due to decreased UroPro 2000 development spending in the current year as the project was substantially completed in the first quarter of 2001.

Selling costs increased to \$713,000 in the second quarter of 2001 compared to \$496,000 in the second quarter of 2000, a change of \$217,000 or 44% due to higher payroll expenses as the Company steps up its sales and marketing staff for the UroPro 2000 sales effort and increased bad debt expense.

General and administrative expenses decreased by \$10,000 or 2% in the three months ended June 30, 2001 compared to the same period in the prior year due to lower consulting expenses partially offset by slightly higher audit expenses.

Gain on sale of investments was approximately \$69,000 in the quarter ended June 30, 2001 compared to \$298,000 in the three months ended June 30, 2000 as the Company sold 28,000 shares of Cardiac Science, Inc. common stock in the current year, whereas the Company sold 53,500 shares of Cardiac Science in the same period of 2000. The net book value of all shares was \$0.

Total minority interest decreased to \$172,000 in the three months ended June 30, 2001 compared to \$209,000 in the same period of the prior year due to lower profits in the Northern Nevada and Southern Idaho operations and recognition of equity income from Medicredit.com, Inc. operations in 2001.

Provision for income taxes for the second quarter of 2001 decreased by \$170,000 as a result of lower taxable income in the current year when compared to the same period of 2000.

Six Months Ended June 30, 2001 Compared to Six Months Ended June 30, 2000

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The Company recorded total revenue of \$10.6 million in the first six months of 2001 or a 12% decrease compared to \$12.1 million in the corresponding period of 2000. Revenues from procedures, maintenance and management fees decreased by \$77,000, or 1%, due to lower average reimbursement per patient even as total patient count increased by 4% in the current year, to over 13,800 patients. Equipment revenue decreased by \$1,409,000, or 56%, as lithotripter shipments decreased from 5 in the six months ended June 30, 2000 to 1 in the same period of 2001. Partially

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offsetting this decline is the increased activity in the Company's imaging tables, as the Company has shipped 47 various types of tables in 2001 with no corresponding units sold in 2000.

Interest income decreased by 7% for the first six months of 2001 when compared to the same period of the prior year as slightly higher interest yields were earned on a substantially lower average invested balance.

Procedure, maintenance and management fee cost of sales increased to 60% of revenue in the six months ended June 30, 2001 compared to 58% in the same period of the prior year as costs stabilized in the fee-for-service program with a corresponding decrease in the per patient revenue realized. Cost of sales on equipment sales increased to 93% of revenue in the first six months of 2001 compared to 69% of revenue in the first six months of 2000 due to lower margins on imaging tables. Overall cost of sales, as a percentage of revenue (excluding interest), increased slightly to 63% in the first half of 2001 compared to 61% in the first half of 2000.

Research and development costs decreased by \$100,000, or 15% in the first six months of 2001 when compared to the same period of 2000 as the Company had funded its development of the UroPro-2000 urology imaging table in 2000 without a corresponding major development project in the current year.

Selling costs increased by 21%, or \$213,000, in the first half of 2001 compared to the same period of 2000 due to higher tradeshow, payroll and outside services with the introduction of the UroPro 2000 and the Company's expansion into radiographic equipment sales.

General and administrative expenses decreased by 5%, or \$70,000, in the six months ended June 30, 2001 compared to the first six months of 2000 due to lower consulting expense and lower professional fees due to the 2000 acquisition of an ownership interest in Medicredit.com, Inc., partially offset by legal expenses resulting from the release of final Stark II regulations.

Gain on sale of investments was \$428,000 in the six months ended June 30, 2001 compared to \$1,081,000 in the six months ended June 30, 2000. In 2001, the Company sold a total of 101,000 shares of Cardiac Science common stock whereas 193,667 shares of Cardiac Science common stock and 5,000 shares of Genstar Therapeutics Corp. (formerly Urogen Corp.) were sold during the same period in 2000. The net book value of all shares sold was \$0.

Minority interest decreased by 26% in the six months ended June 30, 2001 when compared to the same period of the prior year due to decreased profits in the partnership operations and recognition of equity earnings from Medicredit.com, Inc.

Provision for income taxes decreased to \$435,000 in the first six months of 2001 compared to \$1,020,000 for the same period of 2000 as a result of lower taxable income in the current year.

Liquidity and Capital Resources

At June 30, 2001, the Company had cash and short-term investments of approximately \$6.2 million. These funds were generated from continuing operating activities and from the Company's initial public offering in June 1988.

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 2001.

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.

MEDSTONE INTERNATIONAL, INC.
PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Previously reported.

Item 2. Changes in Securities

None

Item 3. Defaults upon Senior Securities

None

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

-
- (a) The annual meeting of stockholders of the Company was held on June 20, 2001.
 - (b) The election of four board of directors of the Company was held. The number of shares cast for each of the individuals listed below to serve until the next Annual Meeting of stockholders and until their successors are elected and have qualified was as follows:

| NAME | FOR | WITHHELD |
|---------------------|-----------|----------|
| ---- | --- | ----- |
| David V. Radlinski | 5,186,137 | 264,744 |
| Frank R. Pope | 5,218,437 | 232,444 |
| Donald John Regan | 5,217,991 | 232,890 |
| Michael C. Tibbitts | 5,217,837 | 233,044 |
| David A. Reed | 5,217,556 | 233,325 |

The ratification of the appointment of Ernst & Young, LLP as independent accountants of the Company for the year ending December 31, 2001.

| | |
|---------|-----------|
| For | 5,436,781 |
| Against | 2,800 |
| Abstain | 11,300 |

Item 5. Other Information
None

Item 6. Exhibits and Reports on Form 8-K

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- (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: August 13, 2001

/s/ Mark Selawski

Mark Selawski
Chief Financial Officer
(Principal financial and

accounting officer)