INTUITIVE SURGICAL INC
Form 10-Q
October 20, 2010
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

*(Mark One)*

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2010

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 000-30713

# Intuitive Surgical, Inc.

**(Exact name of Registrant as specified in its Charter)**

| | |
|---|---|
| **Delaware** | **77-0416458** |
| **(State or Other Jurisdiction of Incorporation or Organization)** | **(I.R.S. Employer Identification Number)** |

**1266 Kifer Road**

**Sunnyvale, California 94086**

**(Address of Principal Executive Offices) (Zip Code)**

**(408) 523-2100**

**(Registrant s Telephone Number, Including Area Code)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO ¨

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

| | | | |
|---|---|---|---|
| Large accelerated filer x | Accelerated filer ¨ | Non-accelerated filer ¨ (Do not check if a smaller reporting company) | Smaller Reporting company ¨ |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO x

The Registrant had 39,293,400 shares of Common Stock, $0.001 par value per share, outstanding as of October 8, 2010.

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## PART I FINANCIAL INFORMATION

**Item 1. Financial Statements**

### INTUITIVE SURGICAL, INC.

### CONDENSED CONSOLIDATED BALANCE SHEETS

### (IN MILLIONS, EXCEPT PAR VALUE)

### (UNAUDITED)

| | September 30, 2010 | December 31, 2009 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 382.0 | $ 221.4 |
| Short-term investments | 598.9 | 334.0 |
| Accounts receivable, net | 207.9 | 205.4 |
| Inventory | 85.0 | 57.6 |
| Prepaids and other assets | 20.3 | 20.9 |
| Deferred tax assets | 7.4 | 7.3 |
| Total current assets | 1,301.5 | 846.6 |
| Property, plant and equipment, net | 156.6 | 125.7 |
| Long-term investments | 639.7 | 616.6 |
| Long-term deferred tax assets | 65.2 | 53.4 |
| Intangible assets, net | 70.6 | 56.2 |
| Goodwill | 116.9 | 110.7 |
| Other assets | 1.3 | 0.5 |
| Total assets | $ 2,351.8 | $ 1,809.7 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 35.7 | $ 27.6 |
| Accrued compensation and employee benefits | 47.2 | 49.8 |
| Deferred revenue | 116.8 | 99.4 |
| Other accrued liabilities | 67.6 | 26.0 |
| Total current liabilities | 267.3 | 202.8 |
| Long-term liabilities | 76.2 | 69.6 |
| Total liabilities | 343.5 | 272.4 |
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Preferred stock, 2.5 shares authorized, $0.001 par value, issuable in series; no shares issued and outstanding as of September 30, 2010 and December 31, 2009 | | |

| | | | | |
|---|---|---|---|---|
| Common stock, 100.0 shares authorized, $0.001 par value, 39.3 and 38.5 shares issued and outstanding as of September 30, 2010 and December 31, 2009, respectively | | | | |
| Additional paid-in capital | | 1,287.5 | | 1,024.3 |
| Retained earnings | | 720.1 | | 511.7 |
| Accumulated other comprehensive income | | 0.7 | | 1.3 |
| Total stockholders equity | | 2,008.3 | | 1,537.3 |
| Total liabilities and stockholders equity | $ | 2,351.8 | $ | 1,809.7 |

See accompanying Notes to Condensed Consolidated Financial Statements.

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**INTUITIVE SURGICAL, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

**(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)**

**(UNAUDITED)**

| | Three Months Ended September 30, 2010 | Three Months Ended September 30, 2009 | Nine Months Ended September 30, 2010 | Nine Months Ended September 30, 2009 |
|---|---|---|---|---|
| Revenue: | | | | |
| Product | $ 287.1 | $ 236.3 | $ 860.4 | $ 604.7 |
| Service | 57.3 | 43.8 | 163.3 | 124.4 |
| Total revenue | 344.4 | 280.1 | 1,023.7 | 729.1 |
| Cost of revenue: | | | | |
| Product | 72.8 | 65.3 | 213.5 | 166.1 |
| Service | 21.0 | 15.8 | 62.3 | 45.1 |
| Total cost of revenue | 93.8 | 81.1 | 275.8 | 211.2 |
| Gross profit | 250.6 | 199.0 | 747.9 | 517.9 |
| Operating expenses: | | | | |
| Selling, general, and administrative | 91.6 | 69.9 | 263.0 | 199.6 |
| Research and development | 26.9 | 24.6 | 83.4 | 69.3 |
| Total operating expenses | 118.5 | 94.5 | 346.4 | 268.9 |
| Income from operations | 132.1 | 104.5 | 401.5 | 249.0 |
| Interest and other income, net | 5.0 | 4.3 | 13.6 | 14.5 |
| Income before taxes | 137.1 | 108.8 | 415.1 | 263.5 |
| Income tax expense | 50.5 | 44.3 | 154.5 | 108.5 |
| Net income | $ 86.6 | $ 64.5 | $ 260.6 | $ 155.0 |
| Earnings per share: | | | | |
| Basic | $ 2.20 | $ 1.69 | $ 6.65 | $ 4.05 |
| Diluted | $ 2.14 | $ 1.64 | $ 6.45 | $ 3.97 |
| Shares used in computing earnings per share: | | | | |
| Basic | 39.4 | 38.1 | 39.2 | 38.3 |
| Diluted | 40.5 | 39.2 | 40.4 | 39.0 |

See accompanying Notes to Condensed Consolidated Financial Statements.

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**INTUITIVE SURGICAL, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(IN MILLIONS)**

**(UNAUDITED)**

| | Nine Months Ended September 30, 2010 | Nine Months Ended September 30, 2009 |
|---|---|---|
| **Operating Activities:** | | |
| Net income | $ 260.6 | $ 155.0 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 17.4 | 14.2 |
| Amortization of intangible assets | 12.2 | 11.7 |
| Deferred income taxes | (11.8) | (15.5) |
| Income tax benefits from employee stock option plans | 49.5 | 8.7 |
| Excess tax benefit from stock-based compensation | (56.3) | (9.2) |
| Share-based compensation expense | 87.5 | 71.9 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (2.4) | (16.4) |
| Inventory | (27.4) | 6.8 |
| Prepaids and other assets | (0.3) | (6.9) |
| Accounts payable | 8.2 | 4.4 |
| Deferred revenue | 17.2 | 12.4 |
| Other accrued liabilities | 49.7 | 32.3 |
| **Net cash provided by operating activities** | 404.1 | 269.4 |
| **Investing Activities:** | | |
| Purchase of investments | (1,032.2) | (523.2) |
| Proceeds from sales and maturities of investments | 745.4 | 417.7 |
| Purchase of property and equipment and acquisition of intellectual property | (86.6) | (45.7) |
| **Net cash used in investing activities** | (373.4) | (151.2) |
| **Financing Activities:** | | |
| Proceeds from issuance of common stock, net | 132.9 | 33.7 |
| Excess tax benefit from stock-based compensation | 56.3 | 9.2 |
| Repurchase and retirement of common stock | (58.9) | (150.0) |
| **Net cash provided by (used in) financing activities** | 130.3 | (107.1) |
| Effect of exchange rate changes on cash and cash equivalents | (0.4) | 0.4 |
| Net increase in cash and cash equivalents | 160.6 | 11.5 |
| Cash and cash equivalents, beginning of period | 221.4 | 194.6 |
| Cash and cash equivalents, end of period | $ 382.0 | $ 206.1 |

See accompanying Notes to Condensed Consolidated Financial Statements.

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**INTUITIVE SURGICAL, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

In this report, Intuitive Surgical, Intuitive, and the Company refer to Intuitive Surgical, Inc and its wholly-owned subsidiaries.

**NOTE 1. DESCRIPTION OF BUSINESS**

Intuitive Surgical, Inc. designs, manufactures, and markets the *da Vinci* Surgical System, which is an advanced surgical system that the Company believes represents a new generation of surgery. The *da Vinci* Surgical System consists of a surgeon s console or consoles, a patient-side cart, a high performance vision system and proprietary wristed instruments. The *da Vinci* Surgical System seamlessly translates the surgeon s natural hand movements on instrument controls at the console into corresponding micro-movements of instruments positioned inside the patient through small puncture incisions, or ports. By placing computer-enhanced technology between the surgeon and the patient, the *da Vinci* Surgical System enables higher value surgical procedures to patients through increased effectiveness and reduced invasiveness.

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Basis of Presentation***

In the opinion of management, the accompanying unaudited Condensed Consolidated Financial Statements ( financial statements ) of Intuitive Surgical, Inc. and its wholly-owned subsidiaries have been prepared on a consistent basis with the December 31, 2009 audited Consolidated Financial Statements and include all adjustments, consisting of only normal recurring adjustments, necessary to fairly state the information set forth herein. These financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ( SEC ), and, therefore, omit certain information and footnote disclosure necessary to present the statements in accordance with U.S. generally accepted accounting principles ( U.S. GAAP ). These financial statements should be read in conjunction with the audited Consolidated Financial Statements and Notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2009, which was filed on January 29, 2010. The results of operations for the first nine months of fiscal 2010 are not indicative of the results to be expected for the entire fiscal year or any future periods.

***New Accounting Standards Recently Adopted***

*Revenue Recognition for Arrangements with Multiple Deliverables*

The Company s revenue consists of product revenue resulting from the sales of systems, instruments and accessories, and service revenue. The Company recognizes revenue when all four revenue recognition criteria have been met: persuasive evidence of an arrangement exists; delivery has occurred or service has been rendered; the price is fixed or determinable; and collectibility is reasonably assured. The Company s revenue recognition policy generally results in revenue recognition at the following points:

> *System sales.* For system sales directly to end customers, revenue is recognized when acceptance occurs, which is deemed to have occurred upon the receipt by the Company of a form executed by the customer acknowledging delivery and/or installation. For system sales through distributors, revenue is recognized upon transfer of title and risk of loss, which is generally at the time of shipment. Distributors do not have price protection rights. The Company s system contracts do not allow rights of return. The Company s system revenue contains a software component. Since the *da Vinci* System s software and non-software elements function together to deliver the System s essential functionality, they are considered to be one deliverable that is excluded from the software revenue recognition guidance.

*Instruments and accessories.* Revenue from sales of instruments and accessories is recognized when the product has been shipped. The Company records an allowance on instruments and accessories sales returns based on historical returns experience.

*Service.* Service contract revenue is recognized ratably over the term of the service period. Revenue related to services performed on a time-and-materials basis is recognized when it is earned and billable.

The Company determined that its multiple-element arrangements are generally comprised of the following elements that would qualify as separate units of accounting: system sales, service contracts and instruments and accessories sales.

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In September 2009, the Financial Accounting Standards Board ( FASB ) amended the accounting standards related to revenue recognition for arrangements with multiple deliverables and arrangements that include software elements ( new accounting principles ). The new accounting principles permit prospective or retrospective adoption, and the Company elected prospective adoption at the beginning of the first quarter of 2010.

For multiple-element arrangements (which are generally comprised of system sales and service contracts) entered into prior to January 1, 2010, revenue was allocated to each element based on the relative fair value of each element. Fair value is generally determined by vendor specific objective evidence (VSOE) which is based on the price charged when each element is sold separately. The Company s systems sales generally include a first year service obligation. The Company typically does not sell the systems on a stand-alone basis and therefore does not have VSOE for its systems. The Company has established VSOE for services. When the fair value of a delivered element had not been established, but fair value existed for the undelivered elements, prior to January 1, 2010, the Company used the residual method to recognize revenue. Under the residual method, the fair value of the undelivered elements was deferred and the remaining portion of the arrangement fee was allocated to the delivered elements.

Subsequent to the adoption of the new revenue accounting principles, for multiple-element arrangements entered into on or after January 1, 2010, revenue is allocated to each element based on their relative selling prices. Relative selling prices are based first on VSOE, then on third-party evidence of selling price (TPE) when VSOE does not exist, and then on estimated selling price (ESP) when VSOE and TPE do not exist.

Because the Company has neither VSOE nor TPE for its systems, the allocation of revenue has been based on the Company s ESPs. The objective of ESP is to determine the price at which the Company would transact a sale if the product was sold on a stand-alone basis. The Company determines ESP for its systems by considering multiple factors including, but not limited to, features and functionality of the system, geographies, type of customer, and market conditions. The Company regularly reviews ESP and maintains internal controls over the establishment and updates of these estimates.

Had the new accounting guidance been applied to revenue at the beginning of 2009, the resultant revenue for the year ended December 31, 2009 would have been substantially the same. Had the new accounting guidance been applied to the three and nine months ended September 30, 2009, system revenue for the three months ended September 30, 2009 would have been approximately $1.5 million lower, while system revenue for the nine months ended September 30, 2009 would have been approximately $1.6 million higher.

*Fair Value Measurements Disclosures*

Effective January 1, 2010, the Company adopted revised guidance intended to improve disclosures related to fair value measurements, issued by FASB. This guidance requires us to separate information about significant transfers in and out of Level 1 and Level 2 and the reason for such transfers, and also requires information related to purchases, sales, issuances, and settlements information of Level 3 financial assets to be included in the rollforward of activity. The guidance also requires us to provide certain disaggregated information on the fair value of financial assets and requires us to disclose valuation techniques and inputs used for both recurring and nonrecurring fair value measurements of our Level 2 and Level 3 financial assets. The Company s policy is to recognize transfers into or out of levels as of the actual date of the event or change in circumstances that caused the transfer.

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**NOTE 3. INVESTMENTS**

The following tables summarize the Company s cash, cash equivalents and investments as of September 30, 2010 and December 31, 2009 (in millions):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| **September 30, 2010** | | | | |
| Cash and cash equivalents: | | | | |
| Cash | $ 35.0 | $ | $ | $ 35.0 |
| Cash equivalents | 347.0 | | | 347.0 |
| Total cash and cash equivalents | $ 382.0 | $ | $ | $ 382.0 |
| Available for sale investments: | | | | |
| Short-term | | | | |
| Commercial paper | $ 62.5 | $ | $ | $ 62.5 |
| Municipal notes | 110.7 | 0.5 | | 111.2 |
| U.S. corporate debt | 164.9 | 0.8 | | 165.7 |
| U.S. treasuries | 103.3 | | | 103.3 |
| U.S. government agencies | 155.9 | 0.3 | | 156.2 |
| Total short-term | $ 597.3 | $ 1.6 | $ | $ 598.9 |
| Long-term | | | | |
| Municipal notes | $ 109.8 | $ 0.6 | $ (4.3) | $ 106.1 |
| U.S. corporate debt | 327.8 | 4.1 | | 331.9 |
| U.S. treasuries | 16.0 | 0.2 | | 16.2 |
| U.S. government agencies | 169.0 | 0.6 | | 169.6 |
| Non-U.S. government securities | 15.7 | 0.2 | | 15.9 |
| Total long-term | $ 638.3 | $ 5.7 | $ (4.3) | $ 639.7 |
| Total cash, cash equivalents and available for sale investments: | $ 1,617.6 | $ 7.3 | $ (4.3) | $ 1,620.6 |

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| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| **December 31, 2009** | | | | |
| Cash and cash equivalents: | | | | |
| Cash | $ 28.6 | $ | $ | $ 28.6 |
| Cash equivalents | 192.8 | | | 192.8 |
| Total cash and cash equivalents | $ 221.4 | $ | $ | $ 221.4 |
| Available for sale investments: | | | | |
| Short-term | | | | |
| Commercial paper | $ 13.1 | $ | $ | $ 13.1 |
| Municipal notes | 21.3 | 0.2 | | 21.5 |
| U.S. corporate debt | 150.5 | 1.3 | | 151.8 |
| U.S. treasuries | 31.6 | 0.2 | | 31.8 |
| U.S. government agencies | 45.5 | 0.5 | | 46.0 |
| Total short-term | $ 262.0 | $ 2.2 | $ | $ 264.2 |
| Long-term | | | | |
| Municipal notes | $ 161.0 | $ 1.5 | $ (4.5) | $ 158.0 |
| U.S. corporate debt | 222.5 | 2.1 | (0.1) | 224.5 |
| U.S. treasuries | 29.5 | | (0.2) | 29.3 |
| U.S. government agencies | 204.6 | 0.6 | (0.4) | 204.8 |
| Total long-term | $ 617.6 | $ 4.2 | $ (5.2) | $ 616.6 |
| Total cash, cash equivalents and available for sale investments | $ 1,101.0 | $ 6.4 | $ (5.2) | $ 1,102.2 |
| Other securities (included in short-term investments): | | | | |
| Trading securities, auction rate securities | $ 62.2 | $ | $ | $ 62.2 |
| Put option | 7.6 | | | 7.6 |
| Total cash, cash equivalents and investments | $ 1,170.8 | $ 6.4 | $ (5.2) | $ 1,172.0 |

The following table summarizes the maturities of the Company s cash equivalents and available-for-sale investments at September 30, 2010 (in millions):

| | Amortized Cost | Fair Value |
|---|---|---|
| Mature in less than one year | $ 944.2 | $ 945.9 |
| Mature in one to five years | 615.5 | 621.1 |
| Mature in more than five years | 22.9 | 18.6 |
| Total | $ 1,582.6 | $ 1,585.6 |

During the three and nine months ended September 30, 2010 and 2009, realized gains or losses recognized on the sale of investments were not significant. As of September 30, 2010 and December 31, 2009, net unrealized gains on available-for-sale securities, net of tax, of $2.1 million and $0.9 million, respectively, were included in accumulated other comprehensive income in the accompanying unaudited Condensed Consolidated Balance Sheets. At September 30, 2010, the majority of the Company s gross unrealized losses were from auction-rate securities (ARS). The Company determined these unrealized losses to be temporary and recorded no other-than-temporary impairments. Factors considered in determining whether a loss is temporary included the length of time and extent to which the investments fair value has been less than the cost basis; the financial condition and near-term prospects of the investee; extent of the loss related to credit of the issuer; the expected cash flows from the security; the Company s intent to sell the security and whether or not the Company will be required to sell the security before the recovery of its amortized cost.

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**NOTE 4. FAIR VALUE MEASUREMENTS**

The Company measures certain financial assets including cash equivalents, available-for-sale securities, trading securities and foreign currency derivatives at their fair value. The fair value of these financial assets was determined based on three levels of inputs, of which the first two are considered observable and the last unobservable, as follows:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The following tables represent the Company s fair value hierarchy for its financial assets and liabilities as of September 30, 2010 and December 31, 2009 (in millions):

| | Fair Value Measurements at September 30, 2010 Using | | | |
|---|---|---|---|---|
| **Assets** | **Level 1** | **Level 2** | **Level 3** | **Total** |
| Available-for-sale securities | | | | |
| Money Market funds | $ 248.6 | $ | $ | $ 248.6 |
| U.S. treasuries | 119.5 | | | 119.5 |
| Commercial paper | | 150.8 | | 150.8 |
| Corporate debt | | 497.6 | | 497.6 |
| U.S. government agencies | | 335.9 | | 335.9 |
| Non-U.S. government agencies | | 15.9 | | 15.9 |
| Municipal notes | | 198.7 | 18.6 | 217.3 |
| **Total assets measured at fair value** | $ 368.1 | $ 1,198.9 | $ 18.6 | $ 1,585.6 |
| **Liabilities** | | | | |
| Foreign Currency Derivatives | $ | | | |