

INTUITIVE SURGICAL INC
Form 10-Q
October 18, 2012
[Table of Contents](#)

UNITED STATES
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, 2012

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.

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

(Exact name of Registrant as specified in its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

77-0416458
(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 ☒ 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 ☒ 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. (Check one):

Large accelerated filer ☒

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 ☒

The Registrant had 39,763,191 shares of Common Stock, \$0.001 par value per share, outstanding as of October 10, 2012.

Table of Contents

INTUITIVE SURGICAL, INC.

TABLE OF CONTENTS

	Page No.
PART I. FINANCIAL INFORMATION	
Item 1. <u>Financial Statements (unaudited):</u>	
<u>Condensed consolidated balance sheets as of September 30, 2012 and December 31, 2011</u>	3
<u>Condensed consolidated statements of comprehensive income for the three-and nine-month periods ended September 30, 2012 and September 30, 2011</u>	4
<u>Condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2012 and September 30, 2011</u>	5
<u>Notes to condensed consolidated financial statements (unaudited)</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	26
Item 4. <u>Controls and Procedures</u>	26
PART II. OTHER INFORMATION	
Item 1. <u>Legal Proceedings</u>	26
Item 1A. <u>Risk Factors</u>	27
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	27
Item 3. <u>Defaults Upon Senior Securities</u>	27
Item 4. <u>Mine Safety Disclosures</u>	27
Item 5. <u>Other Information</u>	27
Item 6. <u>Exhibits</u>	28
<u>Signature</u>	29

Table of Contents**PART I FINANCIAL INFORMATION**

Item 1. Financial Statements

INTUITIVE SURGICAL, INC.**CONDENSED CONSOLIDATED BALANCE SHEETS****(IN MILLIONS, EXCEPT PAR VALUES)****(UNAUDITED)**

	September 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 396.2	\$ 465.8
Short-term investments	745.2	563.4
Accounts receivable, net	336.2	297.9
Inventory	125.8	112.1
Prepays and other current assets	42.6	20.9
Deferred tax assets	7.1	6.2
Total current assets	1,653.1	1,466.3
Property, plant and equipment, net	223.4	197.2
Long-term investments	1,559.7	1,142.6
Long-term deferred tax assets	88.1	69.1
Intangible and other assets, net	69.8	71.0
Goodwill	138.1	116.9
Total assets	\$ 3,732.2	\$ 3,063.1
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 56.1	\$ 45.8
Accrued compensation and employee benefits	74.9	83.1
Deferred revenue	171.8	154.2
Other accrued liabilities	62.1	37.5
Total current liabilities	364.9	320.6
Other long-term liabilities	73.8	96.9
Total liabilities	438.7	417.5
Commitments and contingencies (Note 5)		
Stockholders' equity:		
Preferred stock, 2.5 shares authorized, \$0.001 par value, issuable in series; no shares issued and outstanding as of September 30, 2012 and December 31, 2011		
Common stock, 100.0 shares authorized, \$0.001 par value, 39.8 and 39.3 shares issued and outstanding as of September 30, 2012 and December 31, 2011, respectively		
Additional paid-in capital	2,078.9	1,742.8
Retained earnings	1,208.8	901.9
Accumulated other comprehensive income	5.8	0.9

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Total stockholders' equity	3,293.5	2,645.6
Total liabilities and stockholders' equity	\$ 3,732.2	\$ 3,063.1

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

Table of Contents**INTUITIVE SURGICAL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)****(UNAUDITED)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenue:				
Product	\$ 450.0	\$ 374.9	\$ 1,317.5	\$ 1,057.5
Service	87.8	71.8	252.0	203.0
Total revenue	537.8	446.7	1,569.5	1,260.5
Cost of revenue:				
Product	119.3	96.2	353.9	274.5
Service	28.4	25.0	83.2	75.1
Total cost of revenue	147.7	121.2	437.1	349.6
Gross profit	390.1	325.5	1,132.4	910.9
Operating expenses:				
Selling, general, and administrative	129.0	111.2	374.1	316.8
Research and development	49.7	35.4	128.3	98.8
Total operating expenses	178.7	146.6	502.4	415.6
Income from operations	211.4	178.9	630.0	495.3
Interest and other income (expense), net	4.3	1.9	12.1	11.3
Income before taxes	215.7	180.8	642.1	506.6
Income tax expense	32.4	58.4	160.4	162.7
Net income	\$ 183.3	\$ 122.4	\$ 481.7	\$ 343.9
Net income per share:				
Basic	\$ 4.59	\$ 3.13	\$ 12.10	\$ 8.77
Diluted	\$ 4.46	\$ 3.05	\$ 11.72	\$ 8.55
Shares used in computing net income per share:				
Basic	39.9	39.1	39.8	39.2
Diluted	41.1	40.1	41.1	40.2
Total comprehensive income	\$ 185.5	\$ 121.3	\$ 486.6	\$ 343.8

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

Table of Contents**INTUITIVE SURGICAL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(IN MILLIONS)****(UNAUDITED)**

	Nine Months Ended September 30,	
	2012	2011
Operating Activities:		
Net income	\$ 481.7	\$ 343.9
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	25.2	20.9
Amortization of intangible assets	17.2	13.1
Accretion of discounts and amortization of premiums on investments, net	23.8	16.0
Deferred income taxes	(19.3)	8.2
Income tax benefits from employee stock option plans	54.8	36.2
Excess tax benefit from stock-based compensation	(54.7)	(44.9)
Stock-based compensation expense	115.0	101.8
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(34.8)	(18.2)
Inventory	(11.4)	(21.8)
Prepays and other assets	(5.5)	(7.6)
Accounts payable	6.9	7.5
Accrued compensation and employee benefits	(8.1)	(3.2)
Deferred revenue	16.3	17.7
Other accrued liabilities	(10.1)	(5.7)
Net cash provided by operating activities	597.0	463.9
Investing Activities:		
Purchase of investments	(1,448.8)	(1,176.0)
Proceeds from sales of investments	262.8	371.1
Proceeds from maturities of investments	569.1	532.0
Purchase of property, plant and equipment, intellectual property and business	(53.1)	(67.7)
Acquisition of business, net of cash acquired	(27.6)	
Acquisition-related restricted cash	(15.0)	
Net cash used in investing activities	(712.6)	(340.6)
Financing Activities:		
Proceeds from issuance of common stock, net	176.5	181.6
Excess tax benefit from stock-based compensation	54.7	44.9
Repurchase and retirement of common stock	(185.1)	(331.8)
Net cash provided by (used in) financing activities	46.1	(105.3)
Effect of exchange rate changes on cash and cash equivalents	(0.1)	0.4
Net increase (decrease) in cash and cash equivalents	(69.6)	18.4
Cash and cash equivalents, beginning of period	465.8	279.8

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Cash and cash equivalents, end of period	\$ 396.2	\$ 298.2
--	----------	----------

See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).

Table of Contents

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 designs, manufactures and markets *da Vinci* Surgical Systems and related instruments and accessories, which taken together, are advanced surgical systems that the Company believes represent a new generation of surgery. The Company believes that this new generation of surgery, which the Company calls *da Vinci* Surgery, combines the benefits of minimally invasive surgery (MIS) for patients with the ease of use, precision and dexterity of open surgery. A *da Vinci* Surgical System consists of a surgeon's console, a patient-side cart and a high performance vision system. The *da Vinci* Surgical System translates a surgeon's natural hand movements, which are performed on instrument controls at a console, into corresponding micro-movements of instruments positioned inside the patient through small incisions, or ports. The *da Vinci* Surgical System is designed to provide its operating surgeons with intuitive control, range of motion, fine tissue manipulation capability and 3-D, High-Definition (HD) vision while simultaneously allowing them to work through the small ports of MIS.

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, 2011 audited Consolidated Financial Statements and include all adjustments, consisting of only normal recurring adjustments, necessary to fairly state the information set forth herein. The 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, 2011, which was filed on February 6, 2012. The results of operations for the first nine months of fiscal 2012 are not necessarily indicative of the results to be expected for the entire fiscal year or any future periods. Certain prior year amounts in the financial statements and notes thereto have been reclassified to conform to the current year's presentation.

Revenue Recognition

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 collectability 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* Surgical 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.

Table of Contents

Instruments and accessories. Revenue from sales of instruments and accessories is generally 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.

The Company offers its customers the opportunity to trade in their older systems for credit towards the purchase of a newer generation system. The Company generally does not provide specified trade-in rights or upgrade rights at the time of system purchase. Such trade-in or upgrade transactions are separately negotiated based on the circumstances at the time of the trade-in or upgrade and are generally not based on any pre-existing rights granted by the Company. Accordingly, such trade-ins and upgrades are not considered as separate deliverables in the arrangement for a system sale.

As part of a trade-in transaction, the customer receives a new generation system in exchange for its older used system. The trade-in credit is negotiated at the time of the trade-in and is applied towards the purchase price of the new generation unit. Traded-in systems can be reconditioned and resold. The Company accounts for trade-ins consistent with the guidance in AICPA Technical Practice Aid 5100.01, *Equipment Sales Net of Trade-Ins* (TPA 5100.01). The Company applies the accounting guidance by crediting system revenue for the negotiated price of the new generation system, and the difference between (a) the trade-in allowance and (b) the amount determined by pricing the trade-in system at net realizable value minus a normal profit margin, is treated as a sales allowance. The value of the traded-in system is determined as the amount to which when reconditioning costs are added, will allow a normal profit margin on the sale of the reconditioned unit. When there is no market for the traded-in units, no value is assigned. Traded-in units are reported as a component of inventory until reconditioned and resold, or otherwise disposed.

In addition, customers may also have the opportunity to upgrade their systems, for example, by adding a fourth arm to a three-arm system, adding a second surgeon console for use with the *da Vinci Si* Surgical System or adding new vision systems to the *Standard da Vinci* and *da Vinci S* Surgical Systems. Such upgrades are performed by completing component level upgrades at the customer's site. Upgrade revenue is recognized when the component level upgrades are complete and the four revenue recognition criteria are met.

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. The new accounting principles permit prospective or retrospective adoption, and the Company elected prospective adoption at the beginning of the first quarter of 2010.

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 vendor specific objective evidence (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.

New Accounting Standards Recently Adopted

Effective January 1, 2012, the Company adopted guidance which eliminates the current option to report other comprehensive income (OCI) and its components in the statement of changes in stockholders' equity and elected to disclose OCI in a single continuous statement during interim reporting periods.

Table of Contents

Effective January 1, 2012, the Company adopted the new accounting guidance which allows a qualitative assessment on goodwill impairment to determine whether a quantitative assessment is necessary. The adoption did not have any impact on the Company's consolidated financial statements.

NOTE 3. FINANCIAL INSTRUMENTS***Cash, Cash Equivalents and Investments***

The following tables summarize the Company's cash and available-for-sale securities' amortized cost, gross unrealized gains, gross unrealized losses and fair value by significant investment category recorded as cash and cash equivalents or short-term or long-term investments as of September 30, 2012 and December 31, 2011 (in millions):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short- term Investments	Long- term Investments
September 30, 2012							
Cash	\$ 57.2	\$	\$	\$ 57.2	\$ 57.2	\$	\$
Level 1:							
Money market funds	299.1			299.1	299.1		
U.S. Treasuries & corporate equity securities	205.3	0.2		205.5		155.2	50.3
Subtotal	504.4	0.2		504.6	299.1	155.2	50.3
Level 2:							
Commercial paper	106.5			106.5	39.9	66.6	
Corporate securities	910.8	6.8	(0.1)	917.5		271.7	645.8
U.S. government agencies	666.5	2.9		669.4		133.7	535.7
Non-U.S. government securities	92.0	0.7		92.7		22.8	69.9
Municipal securities	340.6	1.6	(0.1)	342.1		95.2	246.9
Subtotal	2,116.4	12.0	(0.2)	2,128.2	39.9	590.0	1,498.3
Level 3:							
Municipal securities	13.0		(1.9)	11.1			11.1
Subtotal	13.0		(1.9)	11.1			11.1
Total assets measured at fair value	\$ 2,691.0	\$ 12.2	\$ (2.1)	\$ 2,701.1	\$ 396.2	\$ 745.2	\$ 1,559.7

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short- term Investments	Long- term Investments
December 31, 2011							
Cash	\$ 51.6	\$	\$	\$ 51.6	\$ 51.6	\$	\$
Level 1:							
Money market funds	403.2			403.2	403.2		
U.S. Treasuries & corporate equity securities	183.9	0.5		184.4		130.5	53.9
Sub-total	587.1	0.5		587.6	403.2	130.5	53.9

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Level 2:							
Commercial paper	63.5			63.5	11.0	52.5	
Corporate securities	586.6	3.0	(1.4)	588.2		162.4	425.8
U.S. government agencies	521.1	1.4	(0.1)	522.4		126.6	395.8
Non-U.S. government securities	68.7	0.4	(0.1)	69.0		1.3	67.7
Municipal securities	272.1	1.1	(0.1)	273.1		90.1	183.0
Sub-total	1,512.0	5.9	(1.7)	1,516.2	11.0	432.9	1,072.3
Level 3:							
Municipal securities	20.0		(3.6)	16.4			16.4
Sub-total	20.0		(3.6)	16.4			16.4
Total assets measured at fair value	\$ 2,170.7	\$ 6.4	\$ (5.3)	\$ 2,171.8	\$ 465.8	\$ 563.4	\$ 1,142.6

Table of Contents

The following table summarizes the contractual maturities of the Company's cash equivalents and available-for-sale investments, excluding corporate equity securities, at September 30, 2012 (in millions):

	Amortized Cost	Fair Value
Mature in less than one year	\$ 1,082.3	\$ 1,083.5
Mature in one to five years	1,537.9	1,548.6
Mature after five years	13.0	11.1
Total	\$ 2,633.2	\$ 2,643.2

During the three and nine months ended September 30, 2012, realized gains or losses recognized on the sale of investments were not significant. Net realized gains recognized on the sale of investments during the three and nine months ended September 30, 2011 were approximately \$2.5 million. As of September 30, 2012 and December 31, 2011, net unrealized gains (losses), net of tax of \$6.9 million and \$1.1 million, respectively, were included in accumulated other comprehensive income in the accompanying unaudited Condensed Consolidated Balance Sheets. At September 30, 2012, the Company evaluated its gross unrealized losses, the majority of which are from auction-rate securities (ARS), and determined these unrealized losses to be temporary. Factors considered in determining whether a loss is temporary included the length of time and extent to which the investment's fair value has been less than the cost basis; the financial condition and near-term prospects of the issuer; 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.

There have been no transfers between Level 1 and Level 2 measurements since December 31, 2011, and there were no changes in the Company's valuation technique. Level 3 assets consist of ARS whose underlying assets are student loans which are generally backed by the federal government. Since the auctions for these securities have continued to fail since February 2008, these investments are not currently trading and therefore do not have a readily determinable fair value. The Company has valued the ARS using a discounted cash flow model based on Level 3 assumptions, including estimates of, based on data available as of September 30, 2012, interest rates, timing and amount of cash flows, credit and liquidity premiums and expected holding periods of the ARS.

Foreign currency derivatives

The Company had \$2.2 million of derivative liabilities recorded as other accrued liabilities in the Condensed Consolidated Balance Sheets at September 30, 2012, compared to \$3.5 million of derivative assets recorded as prepaid and other assets at December 31, 2011. The derivative assets and liabilities are measured using Level 2 fair value inputs.

Cash Flow Hedges

The Company enters into currency forward contracts as cash flow hedges to hedge certain forecasted revenue transactions denominated in currencies other than the U.S. dollar, primarily the European Euro (Euro or €), the British Pound (GBP or £) and the Korean Won (KRW).

As of September 30, 2012, the Company had notional amounts of \$19.4 million and KRW1.6 billion of outstanding currency forward contracts entered into to hedge Euro and KRW denominated sales, compared to none at December 31, 2011. The net gains (losses) reclassified to revenue related to the hedged revenue transactions for the three and nine months ended September 30, 2012 and 2011 were not significant. Other impacts of derivative instruments designated as cash flow hedges were not significant for the three and nine months ended September 30, 2012 and 2011.

Other Derivatives Not Designated as Hedging Instruments

Other derivatives not designated as hedging instruments consist primarily of forward contracts that the Company uses to hedge intercompany balances and other monetary assets or liabilities denominated in currencies other than the U.S. dollar, primarily the Euro, the GBP, the Swiss Franc (CHF) and the KRW.

Table of Contents

As of September 30, 2012, the Company had notional amounts of 21.7 million, £2.3 million, CHF(1.5) million and KRW6,327.0 million of outstanding currency forward contracts that were entered into to hedge non-functional currency denominated net monetary assets and liabilities, compared to 35.0 million, £1.8 million and CHF(1.7) million at December 31, 2011. For the three months ended September 30, 2012 and 2011, the Company had recognized gains (losses) of approximately \$(0.2) million and \$0.8 million, respectively, in interest and other income (expense), net, related to derivative instruments used to hedge against balance sheet foreign currency exposures. This was offset by approximately \$0 and \$(1.7) million of net foreign exchange gains (losses) during the three months ended September 30, 2012 and 2011, respectively, primarily related to the re-measurement of non-functional currency denominated net monetary assets and liabilities. For the nine months ended September 30, 2012 and 2011, the Company had recognized gains (losses) of approximately \$0.4 million and \$(2.4) million, respectively, in interest and other income (expense), net, related to derivative instruments used to hedge against balance sheet foreign currency exposures. This was offset by approximately \$(0.6) million and \$1.5 million of net foreign exchange gains (losses) during the nine months ended September 30, 2012 and 2011, respectively.

NOTE 4. BALANCE SHEET DETAILS***Inventory***

The following table provides inventory details (in millions):

	September 30, 2012	December 31, 2011
Inventory		
Raw materials	\$ 37.2	\$ 34.8
Work-in-process	3.1	2.5
Finished goods	85.5	74.8
Total	\$ 125.8	\$ 112.1

Goodwill and intangible and other assets

The increases in goodwill and intangible assets as of September 30, 2012 compared with December 31, 2011 were primarily related to the acquisition of the Company's Korean distributor on January 11, 2012. The intangible assets acquired are primarily being amortized over seven years.

NOTE 5. CONTINGENCIES

On August 6, 2010, a shareholder purported class action lawsuit entitled *Perlmutter v. Intuitive Surgical et al.*, No. CV10-3451, was filed against the Company and seven of the Company's current and former officers and directors in the United States District Court for the Northern District of California. The lawsuit seeks unspecified damages on behalf of a putative class of persons who purchased or otherwise acquired the Company's common stock between February 1, 2008 and January 7, 2009. The complaint alleges that the defendants violated federal securities laws by making allegedly false and misleading statements and omitting certain material facts in the Company's filings with the Securities and Exchange Commission. On February 15, 2011, the Police Retirement System of St. Louis was appointed Lead Plaintiff in the case pursuant to the Private Securities Litigation Reform Act of 1995. An amended complaint was filed on April 15, 2011, making allegations substantially similar to the allegations described above. On May 23, 2011 the Company filed a motion to dismiss the amended complaint. On August 10, 2011 that motion was granted and the action was dismissed; the plaintiffs were given 30 days to file an amended complaint. On September 12, 2011, plaintiffs filed their amended complaint. The allegations contained therein are substantially similar to the allegations in the prior complaint. The Company filed a motion to dismiss the amended complaint. A hearing occurred on February 16, 2012, and on May 22, 2012 the Company's motion was granted. The complaint was dismissed with prejudice, and a final judgment was entered in the Company's favor on June 1, 2012. Plaintiffs filed a notice of appeal on June 20, 2012. That appeal remains pending.

Table of Contents

On August 19, 2010, an alleged stockholder caused a purported stockholder's derivative lawsuit entitled *Himmel v. Smith et al.*, No. 1-10-CV-180416, to be filed in the Superior Court of California for the County of Santa Clara naming the Company as a nominal defendant, and naming 14 of the Company's current and former officers and directors as defendants. The lawsuit seeks to recover, for the Company's benefit, unspecified damages purportedly sustained by the Company in connection with allegedly misleading statements and/or omissions made in connection with the Company's financial reporting for the period between February 1, 2008 and January 7, 2009. It also seeks a series of changes to the Company's corporate governance policies and an award of attorneys' fees. On September 15, 2010, another purported stockholder filed an essentially identical lawsuit entitled *Applebaum v. Guthart et al.*, No. 1-10-CV-182645, in the same court against 15 of the Company's current and former officers and directors. On October 5, 2010, the court ordered that the two cases be consolidated for all purposes. By agreement with the plaintiffs, all activity in the case has been stayed pending the results of the appeal in the purported shareholder class action lawsuit discussed above.

Due to the uncertainty surrounding the litigation process, the Company is unable to reasonably estimate the ultimate outcome of the above cases at this time, and therefore no amounts have been accrued related to the outcome of the cases above. Based on currently available information, the Company believes that it has meritorious defenses to the above actions and that the resolution of these cases is not likely to have a material adverse effect on the Company's business, financial position or results of operations.

The Company is also a party to various other legal actions that arose in the ordinary course of its business. The Company does not believe that any of these other legal actions will have a material adverse impact on its business, financial position or results of operations.

NOTE 6. STOCKHOLDERS' EQUITY***Share Repurchase Program***

As of September 30, 2012, the total amount of share repurchases authorized by the Company's Board of Directors (the "Board") and the cumulative share repurchases made to date were \$1,248.7 million and \$865.6 million, respectively. As of September 30, 2012, the remaining authorized amount of share repurchases that may be made under the Board-authorized share repurchase program was approximately \$383.1 million.

The following table provides the share repurchase activities during the three and nine months ended September 30, 2012 and 2011 (in millions, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Shares repurchased	0.3	0.5	0.4	1.0
Average price per share	\$ 495.09	\$ 344.36	\$ 497.28	\$ 344.72
Value of shares repurchased	\$ 169.8	\$ 181.1	\$ 185.1	\$ 331.8

Table of Contents**NOTE 7. STOCK-BASED COMPENSATION*****Stock Option Plans***

A summary of stock option activity under all stock plans for the nine months ended September 30, 2012 is presented as follows (in millions, except per share amounts):

	Shares Available for Grant	Number Outstanding	Stock Options Outstanding Weighted Average Exercise Price Per Share
Balance at December 31, 2011	1.6	4.7	\$ 254.19
Options authorized	1.4		
Options granted	(1.4)	1.4	512.50
Options exercised		(0.7)	214.82
Options forfeited/expired	0.1	(0.2)	361.44
Balance at September 30, 2012	1.7	5.2	\$ 324.59

As of September 30, 2012, 2.7 million options were exercisable at a weighted-average price of \$247.29 per share.

New Option Grant Practice

In the past, annual stock option awards were granted on February 15th (or the next business day if February 15th was not a business day). These stock option awards typically vested 1/8 at the end of six months and 1/48 per month thereafter through a four-year period and had a ten-year term. Beginning in 2012, stock options have been awarded to employees bi-annually on February 15th and August 15th (or the next business day if the date is not a business day). The February 15th stock option awards are subjected to a four-year vesting period, while the August 15th stock option awards are subjected to a 3.5-year vesting period, with 7/48 vesting at the end of one month and 1/48 per month thereafter.

Employee Stock Purchase Plan

Under the Employee Stock Purchase Plan (ESPP), employees purchased approximately 0.1 million shares for \$27.8 million and 0.1 million shares for \$18.5 million during the nine months ended September 30, 2012 and 2011, respectively.

Stock-based Compensation

The following table summarizes stock-based compensation charges (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of sales - products	\$ 4.3	\$ 3.2	\$ 10.6	\$ 9.2
Cost of sales - services	4.1	2.9	9.6	8.2
Total cost of sales	8.4	6.1	20.2	17.4
Selling, general and administrative	28.2	21.4	69.7	63.0
Research and development	10.7	7.4	25.1	21.4
Stock-based compensation expense before income taxes	47.3	34.9	115.0	101.8
Income taxes	14.9	10.4	36.0	32.1

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Stock-based compensation expense after income tax effect	\$ 32.4	\$ 24.5	\$ 79.0	\$ 69.7
--	---------	---------	---------	---------

Table of Contents

The fair value of each option grant and the fair value of the option component of the ESPP shares were estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions, assuming no expected dividends:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Stock Options				
Average risk free interest rate	0.80%	1.13%	0.81%	2.24%
Average expected term (years)	4.1	4.5	4.3	4.8
Average expected volatility	35%	35%	33%	35%
Weighted average fair value at grant date	\$ 148.05	\$ 115.09	\$ 145.60	\$ 114.69
Total stock-based compensation expense (in millions)	\$ 43.3	\$ 32.9	\$ 105.1	\$ 95.7
ESPP				
Average risk free interest rate	0.19%	0.27	0.17%	0.32%
Average expected term (years)	1.3	1.3	1.3	1.3
Average expected volatility	32%	31	32%	33%
Weighted average fair value at grant date	143.36	\$ 112.75	\$ 138.61	\$ 99.94
Total stock-based compensation expense (in millions)	\$ 4.0	\$ 2.0	\$ 9.9	\$ 6.1

NOTE 8. INCOME TAXES

Income tax expense for the three months ended September 30, 2012 was \$32.4 million, or 15.0% of pre-tax income, compared with \$58.4 million, or 32.3% of pre-tax income for the three months ended September 30, 2011. Income tax expense for the nine months ended September 30, 2012 was \$160.4 million, or 25% of pre-tax income, compared with \$162.7 million, or 32.1% of pre-tax income for the nine months ended September 30, 2011. The Company's effective tax rates for all these periods differ from the U.S. federal statutory rate of 35% due primarily to the effect of income earned by certain of the Company's overseas entities being taxed at rates lower than the federal statutory rate partially offset by state income taxes and non-deductible stock option expenses. The Company intends to indefinitely reinvest all of its undistributed foreign earnings outside the United States. The income tax provision for the three and nine months ended September 30, 2012 reflected discrete benefits of \$35.1 million primarily associated with the reversal of unrecognized tax benefits in connection with the expiration of certain statutes of limitations in multiple jurisdictions and \$2.5 million associated with the filing of the Company's 2011 federal tax returns. The income tax provision for the nine months ended September 30, 2012 also included a discrete recognition of certain previously unrecognized tax benefits as a result of new IRS guidance issued in the first quarter of 2012.

As of September 30, 2012, the Company had total gross unrecognized tax benefits of approximately \$81.1 million compared with approximately \$98.1 million as of December 31, 2011, representing a net decrease of approximately \$17.0 million for the nine months ended September 30, 2012. The net decrease is primarily related to the reversal of previously unrecognized tax benefits of \$41.2 million as a result of the expiration of certain statutes of limitations in multiple jurisdictions, and the release of reserves due to re-evaluation of certain previously unrecognized tax positions as a result of new IRS guidance issued in February 2012, partially offset by increases during the first nine months of 2012 related to other uncertain tax positions. Of the total gross unrecognized tax benefits, \$76.8 million and \$93.8 million as of September 30, 2012 and December 31, 2011, respectively, if recognized, would reduce the effective tax rate in the period of recognition. Gross interest related to unrecognized tax benefit accrued was approximately \$4.0 million and \$7.9 million, respectively, as of September 30, 2012 and December 31, 2011, representing a decrease of \$3.9 million related to the expiration of statutes of limitations, net with increase related to other unrecognized tax positions.

The Company files federal, state and foreign income tax returns in many jurisdictions in the United States and abroad. Generally, years before 2009 are closed for most significant jurisdictions except for certain states, for which all years since inception remain open due to utilization of net operating losses and R&D credits generated in prior years or longer statutes of limitations. Certain of the Company's unrecognized tax benefits could reverse based on the normal expiration of various statutes of limitations, which could affect our effective tax rate in the period in which they reverse.

Table of Contents**NOTE 9. NET INCOME PER SHARE**

The following table presents the computation of basic and diluted net income per share (in millions, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$ 183.3	\$ 122.4	\$ 481.7	\$ 343.9
Basic:				
Weighted-average shares outstanding	39.9	39.1	39.8	39.2
Basic net income per share	\$ 4.59	\$ 3.13	\$ 12.10	\$ 8.77
Diluted:				
Weighted-average shares outstanding used in basic calculation	39.9	39.1	39.8	39.2
Add common stock equivalents	1.2	1.0	1.3	1.0
Weighted-average shares used in computing diluted net income per share	41.1	40.1	41.1	40.2
Diluted net income per share	\$ 4.46	\$ 3.05	\$ 11.72	\$ 8.55

Employee stock options to purchase approximately 1.1 million and 2.2 million weighted shares for the three months ended September 30, 2012 and 2011, respectively, and 0.8 million and 2.2 million weighted shares for the nine months ended September 30, 2012 and 2011, respectively, were outstanding, but were not included in the computation of diluted net income per share because the effect of including such shares would have been antidilutive in the periods presented.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

This management's discussion and analysis of financial condition as of September 30, 2012 and results of operations for the three and nine months ended September 30, 2012 and 2011 should be read in conjunction with management's discussion and analysis of financial condition and results of operations included in our Annual Report on Form 10-K for the year ended December 31, 2011.

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements relate to expectations concerning matters that are not historical facts. Words such as estimates, projects, believes, anticipates, plans, expects, intends, may, will, could, should, would, targeted and similar are intended to identify forward-looking statements. These forward-looking statements include, but are not limited to, statements related to our expected business, new product introductions, procedures and procedure adoption, results of operations, future financial position, our ability to increase our revenues, the mix of our revenues between product and service revenues, our financing plans and capital requirements, our costs of revenue, our expenses, our potential tax assets or liabilities, the effect of recent accounting pronouncements, our investments, cash flows and our ability to finance operations from cash flows and similar matters and include statements based on current expectations, estimates, forecasts and projections about the economies and markets in which we operate and our beliefs and assumptions regarding these economies and markets. These forward-looking statements should be considered in light of various important factors, including the following: the impact of global and regional economic and credit market conditions on health care spending; health care reform legislation in the United States and its impact on hospital spending, reimbursement and fees which will be levied on certain medical device revenues; timing and success of product development and market acceptance of developed products; procedure counts; regulatory approvals, clearances and restrictions; guidelines and recommendations in the health care and patient communities; intellectual property positions and litigation; competition in the medical device industry and in the specific markets of surgery in which we operate; unanticipated manufacturing disruptions; the inability to meet demand for products; the results of legal proceedings to which we are or may become a party; our ability to expand into foreign markets; and other risk factors. Readers are cautioned that these forward-looking statements

Table of Contents

are based on current expectation and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those risk factors described throughout this filing and detailed in the Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and other periodic filings with the Securities and Exchange Commission, particularly in Part I, Item 1A: Risk Factors. Our actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

Intuitive®, Intuitive Surgical®, *da Vinci*®, *da Vinci S*®, *da Vinci Si* HD Surgical System, *da Vinci S* HD Surgical System, *da Vinci Si*, *da Vinci Si-e*, *EndoWrist*®, *EndoWrist One*, *Single-Site*, *DVST*®, *Firefly* and *InSite* are trademarks of Intuitive Surgical, Inc.

Overview

Products. We design, manufacture and market *da Vinci* Surgical Systems, which are advanced surgical systems that we believe represent a new generation of surgery. We believe that this new generation of surgery, which we call *da Vinci* surgery, extends the benefits of minimally invasive surgery (MIS) to a broader patient base. The *da Vinci* Surgical System consists of a surgeon's console, or consoles, a patient-side cart and a high performance vision system. The *da Vinci* Surgical System translates the surgeon's natural hand movements, which are performed on instrument controls at a console, into corresponding micro-movements of instruments positioned inside the patient through small incisions, or ports. We believe that the *da Vinci* Surgical System provides the surgeon with intuitive control, range of motion, fine tissue manipulation capability and 3-D, HD vision, while simultaneously allowing the surgeons to work through the small ports of MIS.

By placing computer-enhanced technology between the surgeon and the patient, we believe that the *da Vinci* Surgical System enables surgeons to deliver higher value minimally invasive surgical procedures to their patients. We model patient value as equal to: *procedure efficacy / invasiveness*. Here *procedure efficacy* is a measure of the success of the surgery in resolving the underlying disease and *invasiveness* is how disruptive and painful the treatment is itself. When the patient value of a *da Vinci* procedure is deemed higher than alternate treatment options, patients may seek out surgeons and hospitals that offer that specific *da Vinci* procedure, potentially resulting in a local market share shift for the specific treatment. Adoption occurs procedure by procedure, and is driven by the relative patient value of *da Vinci* procedures compared to alternative treatment options for the same disease state.

Business Model. In our business model, we generate revenue from both the initial capital sales of new and refurbished *da Vinci* Surgical Systems as well as recurring revenue, derived from sales of instruments, accessories, and service. The new and refurbished *da Vinci* Surgical System generally sells for between \$1.0 million and \$2.3 million, depending on configuration and geography, and represents a significant capital equipment investment for our customers. We then generate recurring revenue as our customers consume our *EndoWrist* instruments and accessory products for use in performing procedures with the *da Vinci* Surgical System. *EndoWrist* instruments and accessories have a limited life and will either expire or wear out as they are used in surgery, at which point they are replaced. We also generate recurring revenue from ongoing system service. We typically enter into multi-year service contracts at the time systems are sold generally at an annual rate of approximately \$100,000 to \$170,000 per year, depending on the configuration of the underlying system. The large majority of these service contracts have been renewed at the end of the initial contract periods.

Recurring revenue has grown at a rate equal to or faster than the rate of growth of system revenue. Recurring revenue increased from \$752.7 million, or 53% of total revenue in 2010 to \$979.5 million, or 56% of total revenue in 2011 to \$901.5 million, or 57% of total revenue in the nine months ended September 30, 2012. The increase in recurring revenue relative to system revenue reflects continuing adoption of procedures on a growing base of installed *da Vinci* Surgical Systems and gradually increasing customer utilization per system. We expect recurring revenue to become a larger percentage of total revenue in the future. The installed base of *da Vinci* Surgical Systems has grown to 2,462 at September 30, 2012, compared with 2,132 at December 31, 2011 and 2,031 at September 30, 2011.

We have a direct sales force in the United States, Korea and Europe, excluding Spain, Italy, Greece and Eastern European countries. We utilize distributors in all other markets that we serve. On January 11, 2012, we completed the acquisition of our Korean distributor and began selling directly to Korean customers. The transaction was not material to our financial statements and is not expected to have a material impact on our future operations.

Procedures

The adoption of *da Vinci* surgery has the potential to progress for those procedures that offer greater patient value than non-*da Vinci* alternatives. We model patient value as equal to *procedure efficacy / invasiveness*. Here *procedure efficacy* is a measure of the success

Table of Contents

of the surgery in resolving the underlying disease and *invasiveness* is how disruptive and painful the treatment is itself. When the patient value of robotic surgery is higher than alternate treatment options, patients may seek out surgeons and hospitals that offer that specific *da Vinci* procedure. Adoption occurs procedure by procedure, and is driven by the relative patient value of *da Vinci* procedures compared to alternatives for the same disease state.

We focus our organization and investments on developing, marketing and training those products and procedures where we believe *da Vinci* can bring significant patient value relative to competitive therapies. An increasing body of peer reviewed literature has indicated that *da Vinci* Prostatectomy (dVP) and *da Vinci* Hysterectomy (dVH) may offer improved functional outcomes as compared to traditional open surgery. Similarly, early indications are that *da Vinci* Surgery in our other key surgeries (*da Vinci* Partial Nephrectomy, *da Vinci* Myomectomy, *da Vinci* Sacrocolpopexy, *da Vinci* Mitral Valve Repair, *da Vinci* Lobectomy, *da Vinci* Low Anterior Colon Resections, and *da Vinci* Transoral Robotic Surgery (for cancers of the throat), may also offer improved functional outcomes as compared to traditional open surgery. For many patients, a minimally invasive approach using the *da Vinci* Surgical System may also offer reduced pain, reduced blood loss, shorter hospital stays, reduced post-operative complications and a quicker return to normal daily activities when compared to open surgery.

In 2011, approximately 360,000 surgical procedures were performed with the *da Vinci* Surgical System, up approximately 29% compared with 2010. The growth in our overall procedure volume was driven primarily by *da Vinci* Hysterectomy (dVH) in the U.S., *da Vinci* Prostatectomy (dVP) outside the U.S. and other urologic and gynecologic procedures including Nephrectomy (partial and full), Sacrocolpopexy, Myomectomy and Endometriosis Resection in the U.S. Emerging procedures within other specialties, including lobectomy for lung cancer and low anterior resection for colon cancer also contributed to 2011 procedure growth.

dVH is our highest volume procedure, having surpassed dVP in 2010. dVH procedure volume grew from approximately 110,000 cases in 2010 to approximately 146,000 cases in 2011, of which approximately 39,000 were for the treatment of cancer and the remaining 107,000 related to benign conditions. The very large majority of our 2011 dVH volume came from the U.S. market, where we estimate the total annual addressable robotic market to be approximately 300,000 to 350,000 cases, of which approximately 50,000 are for cancer.

dVP procedure volume grew from approximately 98,000 cases in 2010 to approximately 113,000 cases worldwide in 2011. We estimate that the majority of the approximately 85,000 prostatectomies performed in the U.S. in 2011 were done robotically with the *da Vinci* Surgical System. The majority of our 2011 worldwide dVP growth came from European markets, led by Germany and France.

Other procedures (non-dVH/dVP) grew over approximately 40% in 2011 to approximately 101,000 cases. Growth in these other procedures was driven by *da Vinci* adoption in urologic and gynecologic procedures such as *da Vinci* Partial Nephrectomy and *da Vinci* Sacrocolpopexy as well as early stage growth in other emerging procedures from other surgical specialties, including lobectomy for lung cancer, low anterior resection for colon cancer, and transoral robotic surgery (TORS) for head and neck surgery. While early results in emerging procedures are encouraging and may point to significant patient value, their growth is off of smaller absolute bases and their future growth rates are uncertain.

Total 2012 *da Vinci* procedures through the first three quarters grew approximately 25%, driven by growth in Gynecology and General Surgery procedures in the U.S., partially offset by an approximately 20% reduction in dVP procedures in the U.S. We believe the reduction in dVP procedures in the U.S. primarily reflects pressures from reduced levels of prostate-specific antigen (PSA) testing and increases in non-surgical disease management. dVP s and total procedures have declined in Europe from the first quarter of 2012 to the second and third quarters of 2012, reflecting seasonality and austerity measures as well as the PSA testing and non-surgical disease management trends that have impacted the U.S.

Regulatory Activities

We believe that we have obtained the clearances required to market our products to our targeted surgical specialties within the United States and most of Europe. As we make additions to target procedures and introduce new products, we will continue to seek necessary clearances.

In November 2009, we received regulatory (Shonin) approval from the Japanese Ministry of Health, Labor, and Welfare (MHLW) for our *da Vinci S* System in Japan. We have sold 70 systems into Japan through September 30, 2012. These sales were primarily made to early adopters. Since receiving Shonin approval, we have been focusing our efforts on obtaining specific reimbursement for *da Vinci* procedures in Japan and building our own organization, Intuitive Surgical Japan. Prior to April 2012, we had partnered with the experienced regulatory team from Johnson & Johnson K.K. Medical Company (JJKK) in our Japanese regulatory process. In

Table of Contents

April 2012, the Marketing Authorization Application for *da Vinci* products was transferred to Intuitive Surgical Japan from JKKK, and Intuitive Surgical Japan now has primary responsibility for regulatory support of our products in Japan. We continue to partner with Adachi Co., LTD as our separate independent distribution partner in Japan who is responsible for marketing, selling, and servicing our products in Japan. Effective April 2012, we obtained national reimbursement for dVP procedures in Japan. If we are not successful in obtaining additional regulatory clearances, importation licenses, and adequate procedure reimbursements for future products and procedures, then the demand for our products in Japan could be limited.

2012 Business Events and Trends

Economic Environment. The credit and sovereign debt issues impacting Europe have slowed capital sales and curtailed procedure growth throughout most of 2012. European procedure growth of approximately 17% for the nine months ended September 30, 2012 was lower than we anticipated. Although capital sales and procedure growth outside of Europe have been strong, European uncertainties could adversely impact demand for our products globally. Demand for *da Vinci* systems fluctuates quarter to quarter based upon changing economic and geopolitical factors.

***da Vinci* Prostatectomy.** The U.S. Preventive Service Task Force recommendation against PSA screening, as well as changes in treatment patterns for low risk prostate cancer away from definitive treatment, have led to a decline in our dVP business. We estimate that U.S. dVP declined approximately 20% in the third quarter of 2012 compared with the same period in 2011. We are unable to predict the extent to which these recommendations and treatment pattern changes will be followed by governments or clinicians within non-U.S. jurisdictions.

***da Vinci* Skills Simulator.** In the first quarter of 2011, we began shipping our *da Vinci* Skills Simulator. The simulator is a practice tool for the *da Vinci Si* Surgical System that gives a user the opportunity to practice in his or her facility with the surgeon console controls. The simulator incorporates three-dimensional, physics-based computer simulation technology to immerse the user within a virtual environment. The user navigates through the environment and completes exercises by controlling virtual instruments from the surgeon console. Upon completion of a skills exercise, the simulator provides a quantitative assessment of user performance based on a variety of task-specific metrics. The simulator is intended to augment, not replace, existing training programs for the *da Vinci Si* Surgical System. Most *da Vinci* Skills Simulators have been sold in connection with new *da Vinci Si* Surgical System sales. We sold 87 and 310 *da Vinci* Skills Simulators during the three and nine months ended September, 2012, respectively, compared with 98 and 260 units during the same periods in 2011.

***da Vinci* Single-Site Instruments.** *da Vinci* Single-Site is a set of instruments and accessories that allow the *da Vinci Si* systems to work through a single incision, typically in the umbilicus, rather than multiple incisions. Single incision surgery is intended to minimize trauma to patients by reducing the number of ports required to enter the body. Non-robotic single incision surgery today is typically performed with modified laparoscopic instruments. Early clinical adoption of this manual technique has been mostly positive, however, physicians have reported that manual single incision surgery is technically and ergonomically challenging. *da Vinci* Single-Site instruments and accessories were designed to address these issues. In February 2011, we received the CE mark for our *da Vinci* Single-Site instrument kit and began selling these new products in Europe. The majority of *da Vinci* Single-Site procedures performed in Europe to date has been cholecystectomies. In December 2011, we received Food and Drug Administration (FDA) FDA regulatory clearance to market our *Single-Site* instrumentation in the United States for laparoscopic cholecystectomy procedures, our only United States clearance to date. We are encouraged by early hospital, surgeon, and patient interest in *da Vinci* Single-Site, with over 350 U.S. customers having purchased *da Vinci* Single-Site kits as of September 30, 2012. However, as we are in the early stages of introducing this instrumentation to the U.S. market, we are not able to predict the extent to which *da Vinci* Single-Site may be adopted. We are working on expanding our *da Vinci* Single-Site instrument offering to enable its use in additional indications. In the third quarter of 2012, we submitted and have received from the FDA questions on our 510(k) submission for *da Vinci* Single-Site instruments and indications for use in benign Hysterectomy and Salpingo oophorectomy.

***da Vinci* Firefly Fluorescence Imaging.** In the first quarter of 2011, we launched our *Firefly* Fluorescence Imaging product (*Firefly*) for use with the *da Vinci Si* Surgical System in the U.S. and Europe. This new imaging capability combines a fluorescent dye with a specialized *da Vinci* camera head, endoscope and laser-based illuminator to allow surgeons to identify vasculature in three dimensions beneath tissue surfaces to visualize critical anatomy. *Firefly* kits configured into new *da Vinci* system sales are included in systems revenue, while *Firefly* kits sold separately for existing systems are included in instruments and accessories revenue. Adoption of *Firefly* is progressing, with its primary utilization in partial nephrectomy procedures. *Firefly* is also being used in certain gynecology and general surgery cases.

***EndoWrist One* Vessel Sealer.** In December 2011, we received FDA clearance for the *EndoWrist One* Vessel Sealer. The *EndoWrist One* Vessel Sealer is a wristed, single-use instrument intended for bipolar coagulation and mechanical transection of vessels up to 7 mm in diameter and tissue bundles that fit in the jaws of the instrument. This instrument enables *da Vinci Si* surgeons to fully control vessel sealing, while providing the benefits of *da Vinci* Surgery. This instrument is designed to enhance surgical efficiency and autonomy in a variety of general surgery and gynecologic procedures. Clinical response to the *EndoWrist One* Vessel Sealer has been encouraging, with positive commentary on precision, articulation, vessel sealing quality and thermal spread. We expect applications

Table of Contents

for the *EndoWrist One* Vessel Sealer to be centered on general surgery and gynecologic oncology procedures. We are still in the early stages of introducing *EndoWrist One* Vessel Sealer and are not able to predict the extent to which the *EndoWrist One* Vessel Sealer may be adopted.

Third Quarter 2012 Financial Highlights

Total revenue increased 20% to \$537.8 million during the three months ended September 30, 2012 from \$446.7 million during the three months ended September 30, 2011.

da Vinci procedures performed during the three months ended September 30, 2012 were up approximately 22% compared with the three months ended September 30, 2011.

Instruments and accessories revenue increased 24% to \$218.0 million during the three months ended September 30, 2012 from \$175.8 million during the three months ended September 30, 2011.

Recurring revenue increased 24% to \$305.8 million during the three months ended September 30, 2012, representing 57% of total revenue, from \$247.6 million during the three months ended September 30, 2011, representing 55% of total revenue.

We sold 155 *da Vinci* Surgical Systems during the three months ended September 30, 2012, compared with 133 during the three months ended September 30, 2011.

System revenue increased 17% to \$232.0 million during the three months ended September 30, 2012 from \$199.1 million during the three months ended September 30, 2011.

As of September 30, 2012, we had a *da Vinci* Surgical System installed base of 2,462 systems, 1,789 in the United States, 400 in Europe, and 273 in the rest of the world.

We added 92 employees during the three months ended September 30, 2012, of which the majority were in field sales, service, training, and product operations, bringing our total headcount to 2,192 as of September 30, 2012.

Operating income increased 18% to \$211.4 million during the three months ended September 30, 2012 compared with \$178.9 million during the three months ended September 30, 2011. Operating income included \$47.3 million and \$34.9 million during the three months ended September 30, 2012 and 2011, respectively, of stock-based compensation expense related to employee stock programs.

As of September 30, 2012, we had \$2.7 billion in cash, cash equivalents and investments. Cash, cash equivalents, and investments increased by \$69.9 million during the three months ended September 30, 2012 driven by cash flow from operations and \$38.1 million generated from employee stock programs, partially offset by \$169.8 million of stock repurchases.

Table of Contents**Results of Operations**

The following table sets forth, for the periods indicated, certain unaudited Consolidated Statements of Income information (in millions, except percentages):

	Three months Ended September 30,				Nine months Ended September 30,			
	2012	% of total revenue	2011	% of total revenue	2012	% of total revenue	2011	% of total revenue
Revenue:								
Products	\$ 450.0	84%	\$ 374.9	84%	\$ 1,317.5	84%	\$ 1,057.5	84%
Services	87.8	16%	71.8	16%	252.0	16%	203.0	16%
Total revenue	537.8	100%	446.7	100%	1,569.5	100%	1,260.5	100%
Cost of revenue:								
Products	119.3	22%	96.2	22%	353.9	23%	274.5	22%
Services	28.4	5%	25.0	6%	83.2	5%	75.1	6%
Total cost of revenue	147.7	27%	121.2	27%	437.1	28%	349.6	28%
Products gross profit	330.7	61%	278.7	62%	963.6	61%	783.0	61%
Services gross profit	59.4	11%	46.8	10%	168.8	11%	127.9	10%
Gross profit	390.1	73%	325.5	73%	1,132.4	72%	910.9	72%
Operating expenses:								
Selling, general, and administrative	129.0	24%	111.2	25%	374.1	24%	316.8	25%
Research and development	49.7	9%	35.4	8%	128.3	8%	98.8	8%
Total operating expenses	178.7	33%	146.6	33%	502.4	32%	415.6	33%
Income from operations	211.4	39%	178.9	40%	630.0	40%	495.3	39%
Interest and other income, net	4.3	1%	1.9	0%	12.1	1%	11.3	1%
Income before taxes	215.7	40%	180.8	40%	642.1	41%	506.6	40%
Income tax expense	32.4	5%	58.4	13%	160.4	10%	162.7	13%
Net income	\$ 183.3	34%	\$ 122.4	27%	\$ 481.7	31%	\$ 343.9	27%

Total Revenue

Total revenue was \$537.8 million for the three months ended September 30, 2012, compared with \$446.7 million for the three months ended September 30, 2011. For the nine months ended September 30, 2012, total revenue increased to \$1,569.5 million from \$1,260.5 million for the nine months ended September 30, 2011. Total revenue growth for these periods was driven by the continued adoption of *da Vinci* Surgery, resulting largely from growth in U.S. gynecologic procedures, including dVH, Sacrocolpopexy, Endometriosis Resection, and Myomectomy; U.S. general surgery procedures, including Cholecystectomy and colon procedures; and dVP procedures growth in international markets, partially offset by a decline of approximately 20% in dVP procedures in the U.S. The reduction in dVP procedures in the U.S. reflects pressures from reduced levels of PSA testing and non-surgical disease management. Procedure growth in Europe was lower than our overall growth due to broad economic pressures, structural issues, need for increased depth in our commercial organization as well as the PSA testing and non-surgical disease management trends that have impacted the U.S.

Revenue within the United States accounted for 79% and 80% of total revenue for the three and nine months ended September 30, 2012, and 79% and 78% of total revenue for the three and nine months ended September 30, 2011, respectively. We believe domestic revenue has

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

accounted for the large majority of total revenue primarily due to rapid procedure adoption in the United States driven by the ability of patients to choose their provider and method of treatment. For the three and nine months ended September 30, 2012, international revenue grew in absolute dollars compared with the prior year, primarily due to higher system sales in the Japanese market and higher instrument and accessory sales driven by increased procedures. The credit and sovereign debt issues impacting Europe have slowed capital sales and procedure growth in that region, and our European sales reflect a challenging economic environment.

In September 2012, we entered into a contract with Department of Veteran Affairs (VA) for \$34.0 million of systems, skill simulators and instruments and accessories. The products are required to be delivered to the customer's designated sites within a period of 120 calendar days after the execution of the contract. The contract is cancellable and the customer is not obligated to purchase the full amount of the contract. In September 2012, we entered into a separate contract with Department of Defense for \$34.0 million with a customer for instruments and accessories over a five-year period. The contract is cancellable and the customer is not obligated to purchase the full amount of the contract. No deliveries have occurred under the two contracts during the quarter ended September 30, 2012.

Table of Contents

The following table summarizes our revenue and *da Vinci* Surgical System unit sales for the three and nine months ended September 30, 2012 and 2011 (in millions, except percentages and unit sales):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenue				
Instruments and accessories	\$ 218.0	\$ 175.8	\$ 649.5	\$ 504.7
Systems	232.0	199.1	668.0	552.8
Total product revenue	450.0	374.9	1,317.5	1,057.5
Services	87.8	71.8	252.0	203.0
Total revenue	\$ 537.8	\$ 446.7	\$ 1,569.5	\$ 1,260.5
Recurring revenue	\$ 305.8	\$ 247.6	\$ 901.5	\$ 707.7
% of total revenue	57%	55%	57%	56%
Domestic	\$ 422.6	\$ 352.3	\$ 1,248.6	\$ 988.4
International	115.2	94.4	320.9	272.1
Total revenue	\$ 537.8	\$ 446.7	\$ 1,569.5	\$ 1,260.5
% of Revenue - Domestic	79%	79%	80%	78%
% of Revenue - International	21%	21%	20%	22%
Unit Sales by Region:				
Domestic unit sales	114	99	343	287
International unit sales	41	34	102	95
Total Unit Sales	155	133	445	382
Unit Sales by Model:				
<i>da Vinci Si-e</i> - Single console Unit Sales (3 arm)	6	4	13	11
<i>da Vinci Si</i> - Single console Unit Sales (4 arm)	113	84	327	274
<i>da Vinci Si</i> - Dual console Unit Sales	20	29	73	66
Total <i>da Vinci Si</i> Unit Sales	139	117	413	351
<i>da Vinci S</i> Unit Sales	16	16	32	31
Total Unit Sales	155	133	445	382
Unit Sales involving System Trade-ins:				
Unit sales trading in <i>da Vinci standard</i> Surgical Systems	8	14	39	42
Unit sales trading in <i>da Vinci S</i> Surgical Systems	26	21	76	61
Total unit sales involving trade-ins	34	35	115	103
Unit Sales not trading in any systems	121	98	330	279
Total Unit Sales	155	133	445	382

Table of Contents

Product Revenue

Product revenue was \$450.0 million for the three months ended September 30, 2012 compared with \$374.9 million for the three months ended September 30, 2011.

Instruments and accessories revenue increased 24% to \$218.0 million for the three months ended September 30, 2012 compared with \$175.8 million for the three months ended September 30, 2011. Instrument and accessory revenue growth was driven by approximately 22% higher *da Vinci* surgical procedure volume and revenue generated from initial sales of new instrument and accessory products, including *Single-Site*, *Firefly*, thoracic lung kit and the *EndoWrist One* Vessel Sealer, prior to procedures being performed. Overall procedure growth was led by U.S. gynecologic procedures, driven by dVH, Sacrocolpopexy, Endometriosis Resection, and Myomectomy; U.S. general surgery growth, driven by Cholecystectomy and colon procedures; and dVP growth in international markets partially offset by a decline in dVP procedures in the U.S. by approximately 20%..

Systems revenue increased to \$232.0 million during the three months ended September 30, 2012 from \$199.1 million during the three months ended September 30, 2011 primarily due to higher *da Vinci* system unit sales and a higher average selling price (ASP). We sold 155 *da Vinci* Surgical Systems during the three months ended September 30, 2012, compared with 133 in the same period last year. The growth in system units reflects sales of 16 systems to Japanese customers compared to 6 systems in the same period last year and a greater number of systems sold to U.S. customers; partially offset by 5 fewer systems sold to European customers. The *da Vinci* system ASP was \$1.49 million during the three months ended September 30, 2012, compared with \$1.46 million for the three months ended September 30, 2011, driven primarily by product mix as system sales during the three months ended September 30, 2012 contained a higher proportion of *Firefly* Fluorescence Imaging configurations, which have higher prices than standard HD vision configurations.

Product revenue was \$1,317.5 million for the nine months ended September 30, 2012 compared with \$1,057.5 million for the nine months ended September 30, 2011.

Instruments and accessories revenue increased 29% to \$649.5 million for the nine months ended September 30, 2012 compared with \$504.7 million for the nine months ended September 30, 2011. Instrument and accessory revenue growth was driven by approximately 25% higher *da Vinci* surgical procedure volume and revenue generated from initial sales of new instrument and accessory products, including *da Vinci Single-Site*, *Firefly*, and the *EndoWrist One* Vessel Sealer prior to first cases being completed. Overall procedure growth was led by U.S. gynecologic procedures, driven by dVH, Sacrocolpopexy, Endometriosis Resection, and Myomectomy; U.S. general surgery growth, driven by Cholecystectomy and colon procedures; and dVP growth in international markets partially offset by a decline in dVP in the U.S.

Systems revenue increased to \$668.0 million during the nine months ended September 30, 2012 from \$552.8 million during the nine months ended September 30, 2011 primarily due to higher *da Vinci* system unit sales and a higher average selling price (ASP). We sold 445 *da Vinci* Surgical Systems during the nine months ended September 30, 2012, compared with 382 in the same period last year. The *da Vinci* system ASP was \$1.49 million during the nine months ended September 30, 2012, compared with \$1.43 million for the nine months ended September 30, 2011, driven primarily by product mix as system sales during the nine months ended September 30, 2012 contained a higher proportion of surgical simulator, and *Firefly* Fluorescence Imaging configurations, which have higher prices than standard HD vision configurations and favorable geographical mix.

Service Revenue

Service revenue, comprised primarily of system service and customer training, increased 22% to \$87.8 million for the three months ended September 30, 2012 compared with \$71.8 million for the three months ended September 30, 2011 and increased 24% to \$252.0 million for the nine months ended September 30, 2012 compared with \$203.0 million for the nine months ended September 30, 2011. We typically enter into multi-year, fixed revenue system service contracts at the time systems are sold. The large majority of these service contracts have been renewed at the end of the initial contract periods. Higher service revenue during the three and nine months ended September 30, 2012 was primarily driven by a larger base of *da Vinci* Surgical Systems.

Gross Profit

Product gross profit for the three months ended September 30, 2012 increased 19% to \$330.7 million, or 73.5% of product revenue, compared with \$278.7 million, or 74.3% of product revenue, for the three months ended September 30, 2011. Product gross profit for the nine months ended September 30, 2012 increased 23% to \$963.6 million, or 73.1% of product revenue, compared with \$783.0 million, or 74.0% of product revenue, for the nine months ended September 30, 2011. The higher 2012 product gross profit was driven by higher product revenue, as described above. The slightly lower 2012 product gross profit percentage primarily reflects the introduction of newly launched products

possessing lower margins at their introduction point, particularly *da Vinci Single-Site*

Table of Contents

Instruments and the *EndoWrist One* Vessel Sealer, and higher charges taken for inventory. Margins on newly launched products will typically be lower than our mature products reflecting vendor pricing on low volumes, temporary tooling costs and other start-up costs. Over time as volumes increase, and we refine the manufacturing processes and products, we would expect to see improvement in the margins of these newer products. However, gross margins may ultimately differ for these newer products relative to our previous products based on the volume and complexity of the product. Product gross profit for the three months ended September 30, 2012 and 2011 reflected stock-based compensation expense of \$4.3 million and \$3.2 million, respectively. Product gross profit for the nine months ended September 30, 2012 and 2011 reflected stock-based compensation expense of \$10.6 million and \$9.2 million, respectively.

Service gross profit during the three months ended September 30, 2012 was \$59.4 million, or 67.7% of service revenue, compared with \$46.8 million, or 65.2% of service revenue during the three months ended September 30, 2011. Service gross profit during the nine months ended September 30, 2012 was \$168.8 million, or 67.0% of service revenue, compared with \$127.9 million, or 63.0% of service revenue during the nine months ended September 30, 2011. The higher 2012 service gross profit was driven by a larger installed base of *da Vinci* Surgical Systems. The higher 2012 gross service profit percentage was primarily driven by reduced service parts consumption rates. Service gross profit for the three months ended September 30, 2012 and 2011 reflected stock-based compensation expense of \$4.1 million and \$2.9 million, respectively. Service gross profit for the nine months ended September 30, 2012 and 2011 reflected stock-based compensation expense of \$9.6 million and \$8.2 million, respectively.

In the past, annual stock option awards were granted on February 15th (or the next business day if February 15th was not a business day). These stock option awards typically vested 1/8 at the end of six months and 1/48 per month thereafter through a four-year period and had a ten-year term. Beginning 2012, stock options have been awarded bi-annually on February 15th and August 15th (or the next business day if the date is not a business day). The February 15th stock option awards are subjected to a four-year vesting period, while the August 15th stock option awards are subjected to a 3.5-year vesting period, with 7/48 vesting at the end of one month and 1/48 per month thereafter. As a result of this change in option grant practice our stock-based compensation in the first and second quarters of 2012 was \$34.4 million and \$33.3 million compared to \$47.3 million in the third quarter. As of September 30, 2012, all of the quarterly timing differences related to our revised 2012 employee grant process have cycled through.

Selling, General and Administrative Expenses

Selling, general and administrative expenses include costs for sales, marketing and administrative personnel, proctoring expenses, tradeshow expenses, regulatory fees, and general corporate expenses.

Selling, general and administrative expenses for the three months ended September 30, 2012 increased 16% to \$129.0 million compared with \$111.2 million for the three months ended September 30, 2011. Selling, general and administrative expenses for the nine months ended September 30, 2012 increased 18% to \$374.1 million compared with \$316.8 million for the nine months ended September 30, 2011. The increase in absolute dollars was due to stock-based compensation expenses, organizational growth to support our expanding business, particularly in the clinical field sales function, higher commissions related to higher revenue levels. Stock-based compensation expense during the three months ended September 30, 2012 and 2011 were approximately \$28.2 million and \$21.4 million, respectively. Stock-based compensation expense during the nine months ended September 30, 2012 and 2011 were approximately \$69.7 million and \$63.0 million, respectively.

Please refer to our stock option grant practice discussion in the Gross Profit section above for information on the increase of our stock-based compensation expense in the third quarter of 2012.

Research and Development Expenses

Research and development (R&D) costs are expensed as incurred. R&D expenses include costs associated with the design, development, testing and enhancement of our products. These enhancements represent significant improvements to our products.

R&D expenses for the three months ended September 30, 2012 increased 40% to \$49.7 million compared with \$35.4 million for the three months ended September 30, 2011. R&D expenses for the nine months ended September 30, 2012 increased 30% to \$128.3 million compared with \$98.8 million for the nine months ended September 30, 2011. The increase in absolute dollars was driven by higher stock-based compensation expense, higher prototype costs and growth in our organization. Prototype costs vary by quarter to quarter due to product development life cycles. Amortization expense related to purchased intellectual property during the three months ended September 30, 2012 and 2011 were \$3.2 million and \$3.2 million, respectively. Amortization expense related to purchased intellectual property during the nine months ended September 30, 2012 and 2011 were \$9.8 million and \$10.2 million, respectively. Stock-based compensation expense during the three months ended September 30, 2012 and 2011 were approximately \$10.7 million and \$7.4 million, respectively. Stock-based compensation

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

expense during the nine months ended September 30, 2012 and 2011 were approximately \$25.1 million and \$21.4 million, respectively. We expect to continue to make substantial investments in R&D and anticipate that R&D expense, including co-development arrangements with industry partners, will continue to increase in the future.

Table of Contents

Please refer to our stock option grant practice discussion in the Gross Profit section above for information on the increase of our stock-based compensation expense in the third quarter of 2012.

Interest and Other Income (Expense), Net

Interest and other income, net for the three months ended September 30, 2012 and 2011 was \$4.3 million and \$1.9 million, respectively. This was driven by higher interest income resulting from lower rates earned on higher cash and investment balances and offset by lower other non-operating gains.

Interest and other income, net for the nine months ended September 30, 2012 was \$12.1 million compared with \$11.3 million for the nine months ended September 30, 2011. This was driven by higher interest income resulting from lower rates earned on higher cash and investment balances.

Income Tax Expense

Income tax expense for the three months ended September 30, 2012 was \$32.4 million, or 15.0% of pre-tax income, compared with \$58.4 million, or 32.3% of pre-tax income for the three months ended September 30, 2011. Income tax expense for the nine months ended September 30, 2012 was \$160.4 million, or 25% of pre-tax income, compared with \$162.7 million, or 32.1% of pre-tax income for the nine months ended September 30, 2011. Our effective tax rates for all these periods differ from the U.S. federal statutory rate of 35% due primarily to the effect of income earned by certain of our overseas entities being taxed at rates lower than the federal statutory rate partially offset by state income taxes and non-deductible stock option expenses. We intend to indefinitely reinvest all of our undistributed foreign earnings outside the United States. The income tax provision for the three and nine months ended September 30, 2012 reflected discrete benefits of \$35.1 million primarily associated with the reversal of unrecognized tax benefits in connection with the expiration of certain statutes of limitations in multiple jurisdictions and \$2.5 million associated with the filing of our 2011 federal tax returns. The income tax provision for the nine months ended September 30, 2012 also included a discrete recognition of certain previously unrecognized tax benefits as a result of new IRS guidance issued in the first quarter of 2012.

As of September 30, 2012, we had total gross unrecognized tax benefits of approximately \$81.1 million compared with approximately \$98.1 million as of December 31, 2011, representing a net decrease of approximately \$17.0 million for the nine months ended September 30, 2012. The net decrease is primarily related to the reversal of previously unrecognized tax benefits of \$41.2 million as a result of the expiration of certain statutes of limitations in multiple jurisdictions, and the release of reserves due to re-evaluation of certain previously unrecognized tax positions as a result of new IRS guidance issued in February 2012, partially offset by increases during the first nine months of 2012 related to other uncertain tax positions. Of the total gross unrecognized tax benefits, \$76.8 million and \$93.8 million as of September 30, 2012 and December 31, 2011, respectively, if recognized, would reduce the effective tax rate in the period of recognition. Gross interest related to unrecognized tax benefit accrued was approximately \$4.0 million and \$7.9 million, respectively, as of September 30, 2012 and December 31, 2011, representing a decrease of \$3.9 million related to the expiration of statutes of limitations, net with increase related to other unrecognized tax positions.

We file federal, state and foreign income tax returns in many jurisdictions in the United States and abroad. Generally, years before 2009 are closed for our most significant jurisdictions except for certain states, for which all years since inception remain open due to utilization of net operating losses and R&D credits generated in prior years or longer statutes of limitations. Certain of our unrecognized tax benefits could reverse based on the normal expiration of various statutes of limitations, which could affect our effective tax rate in the period in which they reverse.

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES****Sources and Uses of Cash**

Our principal source of liquidity is cash provided by operations and the exercise of stock options. Cash and cash equivalents plus short and long-term investments increased from \$2.2 billion at December 31, 2011 to \$2.7 billion at September 30, 2012. Cash generation is one of our fundamental strengths and provides us with substantial financial flexibility in meeting our operating, investing and financing needs.

As of September 30, 2012, \$418.8 million of our cash, cash equivalents and investments were held by foreign subsidiaries. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S. We currently have no plans to repatriate any foreign earnings back to the U.S. as we believe our cash flows provided by our U.S. operations will meet our U.S. liquidity needs.

Consolidated Cash Flow Data (unaudited) (in millions)

	Nine Months Ended September 30,	
	2012	2011
Net cash provided by (used in):		
Operating activities	\$ 597.0	\$ 463.9
Investing activities	(712.6)	(340.6)
Financing activities	46.1	(105.3)
Effect of exchange rates on cash and cash equivalents	(0.1)	0.4
Net decrease (increase) in cash and cash equivalents	\$ (69.6)	\$ 18.4

Operating Activities

For the nine months ended September 30, 2012, cash flow from operations of \$597.0 million exceeded our net income of \$481.7 million for two primary reasons:

1. Our net income included substantial non-cash charges in the form of stock-based compensation, amortization of intangible assets, taxes, depreciation and accretion of discounts on investments. These non-cash charges totaled \$162.0 million during the nine months ended September 30, 2012.

2. Cash used in working capital and other assets during the nine months ended September 30, 2012 was approximately \$46.7 million. Working capital is comprised primarily of accounts receivable, inventory, deferred revenue and other liabilities. Accounts receivable increased by \$34.8 million or 13% during the nine months ended September 30, 2012 reflecting timing of our system sales. Inventory increased by \$11.4 million or 12% during the nine months ended September 30, 2012 primarily due to our business growth and expanded product offerings. Other liabilities including accounts payable, accrued compensation and employee benefits, and accrued liabilities decreased by \$11.3 million during the nine months ended September 30, 2012 primarily due to the payments of 2011 incentive compensation and the purchase of stock by employees under the Employee Stock Purchase Plan during the nine months ended September 30, 2012. Deferred revenue increased by \$16.3 million or 11% due to the increase in the number of installed systems for which service contracts exist.

Table of Contents

For the nine months ended September 30, 2011, cash flow from operations of \$463.9 million exceeded our net income of \$343.9 million for two primary reasons:

1. Our net income included substantial non-cash charges in the form of stock-based compensation, amortization of intangible assets, taxes, and depreciation. These non-cash charges totaled \$135.3 million during the nine months ended September 30, 2011.
2. Cash used in working capital and other assets during the nine months ended September 30, 2011 was approximately \$31.3 million. Working capital is comprised primarily of accounts receivable, inventory, deferred revenue and other liabilities. Accounts receivable increased by \$18.2 million or 7% during the nine months ended September 30, 2011 reflecting timing of system sales. Inventory increased by \$21.8 million or 25% during the nine months ended September 30, 2011 due to our business growth, expanded product offerings, and safety stock acquired for key components. Deferred revenue increased \$17.7 million, or 14% during the nine months ended September 30, 2011 due to the increase in the number of installed systems for which service contracts exist.

Investing Activities

Net cash used in investing activities during the nine months ended September 30, 2012 consisted of purchases of investments (net of proceeds from sales and maturities of investments) of \$616.9 million, purchase of property and equipment, intellectual property and business of \$68.1 million, including the increase in acquisition-related restricted cash. Net cash used in investing activities during the nine months ended September 30, 2011 consisted primarily of purchases of investments (net of proceeds from sales and maturities of investments) of \$272.9 million and property, plant and equipment and acquisitions of intellectual property of \$67.7 million. The \$67.7 million of property, plant and equipment and acquisitions of intellectual property includes \$33.1 million in cash used when we completed our purchase of land and buildings near our headquarters in Sunnyvale, California. We invest predominantly in high quality, fixed income securities. Our investment portfolio may at any time contain investments in U.S. Treasury and U.S. government agency securities, taxable and/or tax exempt municipal notes (some of which may have an auction reset feature), corporate notes and bonds, commercial paper, cash deposits and money market funds. We are not a capital intensive business.

Financing Activities

Net cash provided by financing activities during the nine months ended September 30, 2012 consisted primarily of proceeds from stock option exercises and employee stock purchases of \$176.5 million and excess tax benefits from stock-based compensation of \$54.7 million, offset by \$185.1 million used in the repurchase of approximately 372,155 shares of our common stock through open market transactions. Net cash used in financing activities during the nine months ended September 30, 2011 consisted primarily of \$331.8 million for the repurchase of approximately 1.0 million shares of our common stock through open market transactions, offset by proceeds from stock option exercises and employee stock purchases of \$181.6 million and excess tax benefits from stock-based compensation of \$44.9 million.

Our cash requirements depend on numerous factors, including market acceptance of our products, the resources we devote to developing and supporting our products and other factors. We expect to continue to devote substantial resources to expand procedure adoption and acceptance of our products. Based upon our business model, we anticipate that we will continue to be able to fund future growth through cash provided from operations. We believe that our current cash, cash equivalents and investment balances, together with income to be derived from the sale of our products, will be sufficient to meet our liquidity requirements for the foreseeable future.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The discussion and analysis of our financial condition and results of operations are based upon our unaudited Condensed Consolidated Financial Statements, which have been prepared in accordance with U.S. GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an ongoing basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. There have been no material changes to our critical accounting policies and estimates discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in our market risk during the nine months ended September 30, 2012 compared to the disclosures in Part II, Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2011.

ITEM 4. CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

We maintain disclosure controls and procedures, as such term is defined in SEC Rule 13a-15(e), that are designed to ensure that information required to be disclosed in our Securities Exchange Act of 1934 reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by SEC Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we may be involved in a variety of claims, lawsuits, investigations and proceedings relating to securities laws, product liability, patent infringement, contract disputes and other matters relating to various claims that arise in the normal course of our business. Certain of these lawsuits are described in further detail below. We do not know whether we will prevail in these matters nor can we assure that any remedy could be reached on commercially reasonable terms, if at all. Based on currently available information, we believe that we have meritorious defenses to these actions and that the resolution of these cases is not likely to have a material adverse effect on our business, financial position or future results of operations. In accordance with U.S. GAAP, we record a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case.

Purported Shareholder Class Action Lawsuit filed August 6, 2010

On August 6, 2010, a purported class action lawsuit entitled *Perlmutter v. Intuitive Surgical et al.*, No. CV10-3451, was filed against us and seven of our current and former officers and directors in the U.S. District Court for the Northern District of California. The lawsuit seeks unspecified damages on behalf of a putative class of persons who purchased or otherwise acquired our common stock between February 1, 2008 and January 7, 2009. The complaint alleges that the defendants violated federal securities laws by making allegedly false and misleading statements and omitting certain material facts in our filings with the Securities and Exchange Commission. On February 15, 2011, the Police Retirement System of St. Louis was appointed Lead Plaintiff in the case pursuant to the Private Securities Litigation Reform Act of 1995. An amended complaint was filed on April 15, 2011, making allegations

Table of Contents

substantially similar to the allegations described above. On May 23, 2011, we filed a motion to dismiss the amended complaint. On August 10, 2011 that motion was granted and the action was dismissed; the plaintiffs were given 30 days to file an amended complaint. On September 12, 2011, plaintiffs filed their amended complaint. The allegations contained therein are substantially similar to the allegations in the prior complaint. We filed a motion to dismiss the amended complaint. A hearing occurred on February 16, 2012, and on May 22, 2012 the Company's motion was granted. The complaint was dismissed with prejudice, and a final judgment was entered in the Company's favor on June 1, 2012. Plaintiffs filed a notice of appeal on June 20, 2012. That appeal remains pending.

Purported Derivative Actions

On August 19, 2010, an alleged shareholder caused a purported shareholder's derivative lawsuit entitled *Himmel v. Smith et al.*, No. 1-10-CV-180416, to be filed in the Superior Court of California for the County of Santa Clara naming us as a nominal defendant, and naming 14 of our current and former officers and directors as defendants. The lawsuit seeks to recover, for our benefit, unspecified damages purportedly sustained by us in connection with allegedly misleading statements and/or omissions made in connection with our financial reporting for the period between February 1, 2008 and January 7, 2009. It also seeks a series of changes to our corporate governance policies and an award of attorney's fees. On September 15, 2010, another purported shareholder filed an essentially identical lawsuit entitled *Applebaum v. Guthart et al.*, No. 1-10-CV-182645, in the same court against 15 of our current and former officers and directors. On October 5, 2010, the court ordered that the two cases be consolidated for all purposes. By agreement with the plaintiffs, all activity in the case has been stayed pending the results of the appeal in the purported shareholder class action lawsuit discussed above.

ITEM 1A. RISK FACTORS

There have been no changes to the Risk Factors discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

There were no unregistered sales of equity securities during the period covered by this report.

(c) Issuer Purchases of Equity Securities

The table below summarizes our stock repurchase activity for the three months ended September 30, 2012:

Fiscal Period	Total Number of Shares Repurchased	Average Price Paid Per Share	Total Number of Shares Purchased As Part of a Publicly Announced Program	Approximate Dollar Value of Shares That May Yet be Purchased Under the Program
July 1, 2012 to July 31, 2012	11,866	\$ 489.63	11,866	\$ 547.1 million
August 1, 2012 to August 31, 2012	198,592	\$ 497.03	198,592	\$ 448.4 million
September 1, 2012 to September 30, 2012	132,591	\$ 492.67	132,591	\$ 383.1 million
Total during quarter ended September 30, 2012	343,049	\$ 495.09	343,049	\$ 383.1 million

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

27

Table of Contents

ITEM 6. EXHIBITS

Exhibit Number	Description
3.1	Amended and Restated Certificate of Incorporation of Intuitive Surgical, Inc. (incorporated by reference to Exhibit 3.1 on Form 10-K filed with the Securities and Exchange Commission on February 6, 2009).
3.2	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Intuitive Surgical, Inc. (incorporated by reference to Exhibit 3.2 on Form 10-K filed with the Securities and Exchange Commission on February 6, 2009).
3.3	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Intuitive Surgical, Inc (incorporated by reference to Exhibit A to Definitive Proxy Statement on Schedule 14A filed with the Securities and Exchange Commission on March 1, 2012).
3.4	Amended and Restated Bylaws of Intuitive Surgical, Inc. (incorporated by reference to Exhibit 3.1 of the Current Report on Form 8-K filed with the Securities and Exchange Commission on April 24, 2012).
10.1	2009 Employment Commencement Incentive Plan adopted October 22, 2009.
31.1	Certification of the Company's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Company's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Company's Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Company's Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following materials from Intuitive Surgical, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (Extensible Business Reporting Language): (i) the unaudited Condensed Consolidated Balance Sheets, (ii) the unaudited Condensed Consolidated Statements of Income, (iii) the unaudited Condensed Consolidated Statements of Comprehensive Income, (iv) the unaudited Condensed Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements (unaudited), tagged at Level I through IV.

Table of Contents

SIGNATURE

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 thereunto duly authorized.

INTUITIVE SURGICAL, INC.

(Registrant)

By: /s/ MARSHALL L. MOHR
Marshall L. Mohr
Senior Vice President and Chief Financial Officer
(Principal Financial Officer and duly authorized
signatory)

Date: October 18, 2012