

INTUITIVE SURGICAL INC
Form 10-Q
April 19, 2013
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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 March 31, 2013

OR

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

For the transition period from to

Commission file number 000-30713

Intuitive Surgical, Inc.

(Exact name of Registrant as specified in its Charter)

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Delaware
(State or Other Jurisdiction of

77-0416458
(I.R.S. Employer

Incorporation or Organization)

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 40,161,022 shares of Common Stock, \$0.001 par value per share, outstanding as of April 10, 2013.

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Table of Contents**PART I FINANCIAL INFORMATION**

Item 1. Financial Statements

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

	March 31, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 427.5	\$ 553.7
Short-term investments	930.7	770.7
Accounts receivable, net	345.1	370.3
Inventories	135.5	121.5
Prepays and other current assets	46.5	67.3
Deferred tax assets	9.4	9.3
Total current assets	1,894.7	1,892.8
Property, plant and equipment, net	249.9	241.8
Long-term investments	1,757.8	1,596.1
Long-term deferred tax assets	95.6	87.0
Intangible and other assets, net	99.8	103.4
Goodwill	138.0	138.1
Total assets	\$ 4,235.8	\$ 4,059.2
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 67.9	\$ 57.6
Accrued compensation and employee benefits	66.0	104.0
Deferred revenue	192.1	185.7
Other accrued liabilities	51.6	54.3
Total current liabilities	377.6	401.6
Other long-term liabilities	86.0	77.5
Total liabilities	463.6	479.1
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 March 31, 2013 and December 31, 2012, respectively		
Common stock, 100.0 shares authorized, \$0.001 par value, 40.2 shares and 40.2 shares outstanding as of March 31, 2013 and December 31, 2012, respectively		
Additional paid-in capital	2,378.5	2,240.1
Retained earnings	1,385.6	1,333.4
Accumulated other comprehensive income	8.1	6.6

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Total stockholders' equity	3,772.2	3,580.1
Total liabilities and stockholders' equity	\$ 4,235.8	\$ 4,059.2

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 March 31,	
	2013	2012
Revenue:		
Product	\$ 517.0	\$ 414.4
Service	94.4	80.8
Total revenue	611.4	495.2
Cost of revenue:		
Product	146.3	111.7
Service	30.8	27.6
Total cost of revenue	177.1	139.3
Gross profit	434.3	355.9
Operating expenses:		
Selling, general and administrative	141.5	124.2
Research and development	41.6	38.4
Total operating expenses	183.1	162.6
Income from operations	251.2	193.3
Interest and other income (expense), net	4.3	3.8
Income before taxes	255.5	197.1
Income tax expense	66.6	53.6
Net income	\$ 188.9	\$ 143.5
Net income per share:		
Basic	\$ 4.69	\$ 3.63
Diluted	\$ 4.56	\$ 3.50
Shares used in computing net income per share:		
Basic	40.3	39.5
Diluted	41.4	41.0
Total comprehensive income	\$ 190.4	\$ 144.1

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

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

	Three Months Ended March 31,	
	2013	2012
Operating activities:		
Net income	\$ 188.9	\$ 143.5
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	10.4	7.5
Amortization of intangible assets	5.6	5.8
Accretion of discounts and amortization of premiums on investments, net	9.8	7.0
Deferred income taxes	(9.5)	(1.4)
Income tax benefits from employee stock option plans	19.9	20.2
Excess tax benefit from stock-based compensation	(20.6)	(20.2)
Stock-based compensation expense	38.2	34.4
Changes in operating assets and liabilities, net of effects of acquisition:		
Accounts receivable	25.3	1.6
Inventories	(15.8)	(6.0)
Prepays and other assets	18.5	(3.4)
Accounts payable	10.3	0.5
Accrued compensation and employee benefits	(38.0)	(25.2)
Other liabilities	15.0	0.7
Net cash provided by operating activities	258.0	165.0
Investing activities:		
Purchase of investments	(576.0)	(646.3)
Proceeds from sales of investments	50.0	133.2
Proceeds from maturities of investments	194.7	153.2
Purchase of property, plant and equipment, intellectual property and business	(16.7)	(48.3)
Net cash used in investing activities	(348.0)	(408.2)
Financing activities:		
Proceeds from issuance of common stock, net	89.3	82.9
Excess tax benefit from stock-based compensation	20.6	20.2
Repurchase and retirement of common stock	(145.7)	
Net cash provided by (used in) provided by financing activities	(35.8)	103.1
Effect of exchange rate changes on cash and cash equivalents	(0.4)	0.2
Net increase (decrease) in cash and cash equivalents	(126.2)	(139.9)
Cash and cash equivalents, beginning of period	553.7	465.8
Cash and cash equivalents, end of period	\$ 427.5	\$ 325.9

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

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INTUITIVE SURGICAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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

NOTE 1. DESCRIPTION OF BUSINESS

Intuitive 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 audited Consolidated Financial Statements for the fiscal year ended December 31, 2012 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, 2012, which was filed on February 4, 2013. The results of operations for the first three months of fiscal 2013 are not necessarily indicative of the results to be expected for the entire fiscal year or any future periods.

New Accounting Standards Recently Adopted

Effective January 1, 2013 the Company adopted the accounting guidance which requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. The Company elected to present the information in the notes to the Company's unaudited condensed consolidated financial statements.

Effective January 1, 2013 the Company adopted the accounting standard which requires an entity to provide enhanced disclosures about certain financial instruments and derivative instruments that are offset in the statement of financial position or that are subject to enforceable master netting arrangements. The adoption did not have any impact on the Company's unaudited condensed consolidated financial statements.

Table of Contents**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 March 31, 2013 and December 31, 2012 (in millions):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short-term Investments	Long-term Investments
March 31, 2013							
Cash	\$ 66.8	\$	\$	\$ 66.8	\$ 66.8	\$	\$
Level 1:							
Money market funds	263.2			263.2	263.2		
U.S. Treasuries	200.3	0.1		200.4		179.0	21.4
Subtotal	463.5	0.1		463.6	263.2	179.0	21.4
Level 2:							
Commercial paper	181.4			181.4	81.5	99.9	
Corporate securities	1,104.0	5.3	(0.2)	1,109.1	10.0	395.2	703.9
U.S. government agencies	668.8	2.4		671.2	6.0	115.5	549.7
Non-U.S. government securities	90.2	0.5		90.7		23.0	67.7
Municipal securities	524.1	1.7		525.8		118.1	407.7
Subtotal	2,568.5	9.9	(0.2)	2,578.2	97.5	751.7	1,729.0
Level 3:							
Municipal securities	8.0		(0.6)	7.4			7.4
Subtotal	8.0		(0.6)	7.4			7.4
Total assets measured at fair value	\$ 3,106.8	\$ 10.0	\$ (0.8)	\$ 3,116.0	\$ 427.5	\$ 930.7	\$ 1,757.8

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short-term Investments	Long-term Investments
December 31, 2012							
Cash	\$ 89.7	\$	\$	\$ 89.7	\$ 89.7	\$	\$
Level 1:							
Money market funds	388.1			388.1	388.1		
U.S. Treasuries & corporate equity securities	179.2	0.2		179.4		155.4	24.0
Subtotal	567.3	0.2		567.5	388.1	155.4	24.0
Level 2:							
Commercial paper	157.4			157.4	75.9	81.5	
Corporate securities	952.1	5.8	(0.4)	957.5		274.6	682.9
U.S. government agencies	636.9	2.6		639.5		133.6	505.9
Non-U.S. government securities	90.8	0.5		91.3		21.8	69.5
Municipal securities	409.3	1.1	(0.2)	410.2		103.8	306.4

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Subtotal	2,246.5	10.0	(0.6)	2,255.9	75.9	615.3	1,564.7
Level 3:							
Municipal securities	8.0		(0.6)	7.4			7.4
Subtotal	8.0		(0.6)	7.4			7.4
Total assets measured at fair value	\$ 2,911.5	\$ 10.2	\$ (1.2)	\$ 2,920.5	\$ 553.7	\$ 770.7	\$ 1,596.1

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The following table summarizes the contractual maturities of the Company's cash equivalents and available-for-sale investments, excluding corporate equity securities, at March 31, 2013 (in millions):

	Amortized Cost	Fair Value
Mature in less than one year	\$ 1,289.8	\$ 1,291.4
Mature in one to five years	1,742.2	1,750.4
Mature in after five years	8.0	7.4
Total	\$ 3,040.0	\$ 3,049.2

Net realized gains or losses recognized on the sale of investments during the three month periods ended March 31, 2013 and 2012, respectively, were not significant. As of March 31, 2013 and December 31, 2012, net unrealized gains (losses) of \$7.3 million and \$6.2 million, respectively, were included in accumulated other comprehensive income in the accompanying unaudited Condensed Consolidated Balance Sheets.

There have been no transfers between Level 1 and Level 2 measurements during the three months ended March 31, 2013, and there were no changes in the Company's valuation technique. Level 3 assets consist of municipal bonds with auction rate securities (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 March 31, 2013, interest rates, timing and amount of cash flows, credit and liquidity premiums and expected holding periods of the ARS.

Foreign currency derivatives

The Company has \$2.4 million of derivative assets recorded as prepaid and other current assets in the unaudited Condensed Consolidated Balance Sheets at March 31, 2013, compared to \$2.7 million of derivative liabilities recorded as other accrued liabilities in the Condensed Consolidated Balance Sheets at December 31, 2012. 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 €) and the Korean Won (KRW).

As of March 31, 2013, the Company had notional amounts of \$9.8 million and KRW2.2 billion of outstanding currency forward contracts entered into to hedge Euro and KRW denominated sales, compared to \$20.0 million and KRW4.4 billion of outstanding currency forward contracts at December 31, 2012. The net gains (losses) reclassified to revenue related to the hedged revenue transactions for the three months ended March 31, 2013 and 2012 were not significant. Other impacts of derivative instruments designated as cash flow hedges were not significant for the three months ended March 31, 2013 and 2012.

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 British Pound (£ or GBP), the Swiss Franc (CHF), Japanese Yen (JPY) and the KRW.

As of March 31, 2013, the Company had notional amounts of \$21.9 million, £2.5 million, CHF1.0 million, JPY1.2 million and KRW6.6 billion of outstanding currency forward contracts that were entered into to hedge non-functional currency denominated net monetary assets and liabilities, compared to \$37.6 million, £5.4 million, CHF(1.0) million and KRW4.6 billion at December 31, 2012. For the three months ended March 31, 2013 and 2012, the Company had recognized gains (losses) of approximately \$1.0 million and \$(0.5) 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 \$(1.4) million and \$0.5 million of net foreign exchange gains (losses) during the three months ended March 31, 2013 and 2012, respectively, primarily related to the re-measurement of non-functional currency denominated net monetary assets and liabilities.

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The following table summarizes the Company's inventories as of March 31, 2013 and December 31, 2012 (in millions):

	March 31, 2013	December 31, 2012
Raw materials	\$ 43.8	\$ 41.2
Work-in-process	4.0	4.4
Finished goods	87.7	75.9
Total inventories	\$ 135.5	\$ 121.5

NOTE 5. CONTINGENCIES

On August 6, 2010, a purported class action lawsuit entitled *Perlmutter v. Intuitive Surgical et al.*, No. CV10-3451, was filed against seven of our 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 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 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 our motion was granted. The complaint was dismissed with prejudice, and a final judgment was entered in our favor on June 1, 2012. On June 20, 2012, plaintiffs filed a notice of appeal with the United States Court of Appeals for the Ninth Circuit. The appeal is styled *Police Retirement System of St. Louis v. Intuitive Surgical, Inc. et al.*, No. 12-16430. Plaintiffs filed their opening brief on September 28, 2012. The Company filed an answering brief on November 13, 2012, and plaintiffs filed a reply brief on December 17, 2012. No oral argument date has been set, and the appeal remains pending.

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 us 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 us 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.

The Company is currently a defendant in approximately 26 individual product liability lawsuits filed in various state and federal courts by plaintiffs who allege that they underwent surgical procedures that utilized the *da Vinci* Surgical System and sustained a variety of personal injuries and, in some cases, death as a result of such surgery. The cases raise a variety of allegations including, to varying degrees, that their injuries resulted from purported defects in the *da Vinci* Surgical System and/or failure on the part of the Company to provide adequate training resources to the healthcare professionals who performed plaintiffs' surgeries. The cases further allege that the Company failed to adequately disclose and/or misrepresented the potential risks and/or benefits of the *da Vinci* Surgical System. Plaintiffs also assert a variety of causes of action, including for example, strict liability based on purported design defects, negligence, fraud, breach of express and implied warranties, unjust enrichment, and loss of consortium. Plaintiffs seek recovery for alleged personal injuries and, in many cases, punitive damages. Except for the case described below, these cases generally are in the early stages of pretrial activity.

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On December 17, 2009, a product liability action entitled *Josette Taylor, as Personal Representative of the Estate of Fred E. Taylor, deceased; and on behalf of the Estate of Fred E. Taylor; and Josette Taylor v. Intuitive Surgical, Inc.*, No. 09-2-03136-5, was filed in Washington State Superior Court for Kitsap County against the Company and the healthcare providers and hospital involved in decedent's surgery. In Taylor, plaintiffs assert wrongful death and product liability claims against the Company, generally alleging that the decedent died four years after surgery as a result of injuries purportedly suffered during the surgery, which was conducted with the use of the *da Vinci* Surgical System. The plaintiffs in Taylor assert that such injuries were caused, in whole or in part, by the Company's purported failure to properly train, warn, and instruct the surgeon. The lawsuit seeks unspecified damages for past medical expenses, pain and suffering, loss of consortium as well as punitive damages. A trial commenced in the action on April 15, 2013.

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Plaintiffs' attorneys are engaged in growing and well-funded national advertising campaigns soliciting clients who have undergone *da Vinci* surgery and claim to have suffered an injury. The Company has seen a substantial increase in these claims, however it has only received detailed information regarding a small number of them. In an effort to provide an orderly process for evaluating claims before they result in costly litigation, we have entered into tolling agreements with certain plaintiff's counsel acting on behalf of such claimants. The tolling agreements provide that the statute of limitations for each individual will be tolled for a period of three to six months in exchange for the individual's agreement that, if he or she ultimately files a lawsuit, it will be filed in certain agreed upon venues. The tolling agreements provide the parties and their legal counsel with additional time to evaluate the claims, to explore whether the claims have merit and whether they can be resolved without litigation. The Company does not currently know how many of such individuals will ultimately fi