

INTUITIVE SURGICAL INC

Form 10-Q

July 22, 2013

[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 June 30, 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)

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

**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 39,709,905 shares of Common Stock, \$0.001 par value per share, outstanding as of July 10, 2013.

**Table of Contents**

**INTUITIVE SURGICAL, INC.**

**TABLE OF CONTENTS**

	<b>Page No.</b>
<b>PART I. FINANCIAL INFORMATION</b>	
Item 1. <u>Financial Statements (unaudited):</u>	
<u>Condensed consolidated balance sheets as of June 30, 2013 and December 31, 2012</u>	3
<u>Condensed consolidated statements of comprehensive income for the three and six months ended June 30, 2013 and 2012</u>	4
<u>Condensed consolidated statements of cash flows for the six months ended June 30, 2013 and 2012</u>	5
<u>Notes to condensed consolidated financial statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	25
Item 4. <u>Controls and Procedures</u>	25
<b>PART II. OTHER INFORMATION</b>	
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>	28
Item 3. <u>Defaults Upon Senior Securities</u>	28
Item 4. <u>Mine Safety Disclosures</u>	28
Item 5. <u>Other Information</u>	28
Item 6. <u>Exhibits</u>	29
<u>Signature</u>	30

**Table of Contents****PART I FINANCIAL INFORMATION**

## Item 1. Financial Statements

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

	June 30, 2013	December 31, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 432.7	\$ 553.7
Short-term investments	857.5	770.7
Accounts receivable, net	358.6	370.3
Inventories	169.3	121.5
Prepays and other current assets	33.4	67.3
Deferred tax assets	9.5	9.3
Total current assets	1,861.0	1,892.8
Property, plant and equipment, net	267.6	241.8
Long-term investments	1,737.0	1,596.1
Long-term deferred tax assets	106.2	87.0
Intangible and other assets, net	92.1	103.4
Goodwill	137.4	138.1
Total assets	\$ 4,201.3	\$ 4,059.2
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 67.2	\$ 57.6
Accrued compensation and employee benefits	70.0	104.0
Deferred revenue	196.7	185.7
Other accrued liabilities	57.0	54.3
Total current liabilities	390.9	401.6
Other long-term liabilities	91.6	77.5
Total liabilities	482.5	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 June 30, 2013 and December 31, 2012, respectively		
Common stock, 100.0 shares authorized, \$0.001 par value, 39.7 shares and 40.2 shares outstanding as of June 30, 2013 and December 31, 2012, respectively		
Additional paid-in capital	2,428.0	2,240.1
Retained earnings	1,292.9	1,333.4
Accumulated other comprehensive income (loss)	(2.1)	6.6

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Total stockholders' equity	3,718.8	3,580.1
Total liabilities and stockholders' equity	\$ 4,201.3	\$ 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)**

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
<b>Revenue:</b>				
Product	\$ 480.4	\$ 453.1	\$ 997.4	\$ 867.5
Service	98.1	83.4	192.5	164.2
<b>Total revenue</b>	<b>578.5</b>	<b>536.5</b>	<b>1,189.9</b>	<b>1,031.7</b>
<b>Cost of revenue:</b>				
Product	140.9	122.9	287.2	234.6
Service	32.4	27.2	63.2	54.8
<b>Total cost of revenue</b>	<b>173.3</b>	<b>150.1</b>	<b>350.4</b>	<b>289.4</b>
<b>Gross profit</b>	<b>405.2</b>	<b>386.4</b>	<b>839.5</b>	<b>742.3</b>
<b>Operating expenses:</b>				
Selling, general and administrative	145.5	120.9	287.0	245.1
Research and development	41.2	40.2	82.8	78.6
<b>Total operating expenses</b>	<b>186.7</b>	<b>161.1</b>	<b>369.8</b>	<b>323.7</b>
<b>Income from operations</b>	<b>218.5</b>	<b>225.3</b>	<b>469.7</b>	<b>418.6</b>
Interest and other income (expense), net	4.3	4.0	8.6	7.8
<b>Income before taxes</b>	<b>222.8</b>	<b>229.3</b>	<b>478.3</b>	<b>426.4</b>
Income tax expense	63.7	74.4	130.3	128.0
<b>Net income</b>	<b>\$ 159.1</b>	<b>\$ 154.9</b>	<b>\$ 348.0</b>	<b>\$ 298.4</b>
<b>Net income per share:</b>				
Basic	\$ 3.99	\$ 3.88	\$ 8.68	\$ 7.52
Diluted	\$ 3.90	\$ 3.75	\$ 8.47	\$ 7.26
<b>Shares used in computing net income per share:</b>				
Basic	39.9	39.9	40.1	39.7
Diluted	40.8	41.3	41.1	41.1
<b>Total comprehensive income</b>	<b>\$ 148.9</b>	<b>\$ 157.0</b>	<b>\$ 339.3</b>	<b>\$ 301.1</b>

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



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

	<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>Operating activities:</b>		
Net income	\$ 348.0	\$ 298.4
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	21.3	15.2
Amortization of intangible assets	11.3	12.0
Accretion of discounts and amortization of premiums on investments, net	20.2	15.2
Deferred income taxes	(15.7)	(6.1)
Income tax benefits from employee stock option plans	25.8	44.7
Excess tax benefit from stock-based compensation	(26.5)	(44.7)
Share-based compensation expense	76.9	67.7
Changes in operating assets and liabilities, net of effects of acquisition:		
Accounts receivable	11.7	(21.9)
Inventories	(53.2)	(12.2)
Prepays and other assets	16.1	(4.4)
Accounts payable	9.7	5.4
Accrued compensation and employee benefits	(34.0)	(8.4)
Other liabilities	35.5	14.9
Net cash provided by operating activities	447.1	375.8
<b>Investing activities:</b>		
Purchase of investments	(947.6)	(1,022.9)
Proceeds from sales of investments	257.2	229.4
Proceeds from maturities of investments	441.1	324.8
Purchase of property, plant and equipment, intellectual property and business	(41.7)	(56.4)
Net cash used in investing activities	(291.0)	(525.1)
<b>Financing activities:</b>		
Proceeds from issuance of common stock, net	112.1	138.5
Excess tax benefit from stock-based compensation	26.5	44.7
Repurchase and retirement of common stock	(415.4)	(15.2)
Net cash provided by (used in) provided by financing activities	(276.8)	168.0
Effect of exchange rate changes on cash and cash equivalents	(0.3)	(0.1)
Net increase (decrease) in cash and cash equivalents	(121.0)	18.6
Cash and cash equivalents, beginning of period	553.7	465.8
Cash and cash equivalents, end of period	\$ 432.7	\$ 484.4



Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

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*<sup>®</sup> Surgical Systems and related instruments and accessories, which taken together, are advanced surgical systems that the Company considers a new generation of surgery. 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 Three Dimensional ( 3-D ), High-Definition ( HD ) vision while simultaneously allowing surgeons to work through the small ports enabled by MIS procedures.

**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 United States ( 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 six 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.

In June 2013, the Financial Accounting Standards Board determined that an unrecognized tax benefit should be presented as a reduction of a deferred tax asset for a net operating loss ( NOL ) carryforward or other tax credit carryforward when settlement in this manner is available under applicable tax law. This guidance is effective for the Company's interim and annual periods beginning January 1, 2014. The Company does not believe the adoption of this guidance will have a material impact on its 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 June 30, 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
<b>June 30, 2013</b>							
<b>Cash</b>	\$ 61.4	\$	\$	\$ 61.4	\$ 61.4	\$	\$
<b>Level 1:</b>							
Money market funds	332.0			332.0	332.0		
U.S. Treasuries	87.4	0.1	(0.5)	87.0		30.0	57.0
Subtotal	419.4	0.1	(0.5)	419.0	332.0	30.0	57.0
<b>Level 2:</b>							
Commercial paper	152.0			152.0	39.3	112.7	
Corporate securities	1,086.1	3.3	(4.2)	1,085.2		414.9	670.3
U.S. government agencies	629.7	1.1	(2.1)	628.7		128.5	500.2
Non-U.S. government securities	80.7	0.2	(0.2)	80.7		42.2	38.5
Municipal securities	593.1	0.9	(1.2)	592.8		129.2	463.6
Subtotal	2,541.6	5.5	(7.7)	2,539.4	39.3	827.5	1,672.6
<b>Level 3:</b>							
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	\$ 3,030.4	\$ 5.6	\$ (8.8)	\$ 3,027.2	\$ 432.7	\$ 857.5	\$ 1,737.0

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short- term Investments	Long- term Investments
<b>December 31, 2012</b>							
<b>Cash</b>	\$ 89.7	\$	\$	\$ 89.7	\$ 89.7	\$	\$
<b>Level 1:</b>							
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
<b>Level 2:</b>							
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

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

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

**Table of Contents**

The following table summarizes the contractual maturities of the Company's cash equivalents and available-for-sale securities, excluding corporate equity securities, at June 30, 2013 (in millions):

	Amortized Cost	Fair Value
Mature in less than one year	\$ 1,227.0	\$ 1,228.8
Mature in one to five years	1,734.0	1,729.6
Mature in after five years	8.0	7.4
Total	\$ 2,969.0	\$ 2,965.8

Net realized gains or losses recognized on the sale of investments during the three and six month periods ended June 30, 2013 and 2012, were not significant. As of June 30, 2013 and December 31, 2012, net unrealized gains (losses) of \$(2.8) 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 six months ended June 30, 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 June 30, 2013, interest rates, timing and amount of cash flows, credit and liquidity premiums and expected holding periods of the ARS.

**Foreign currency derivatives**

The objective of the Company's hedging program is to mitigate the impact of changes in currency exchange rates on net cash flow from foreign currency denominated sales and intercompany balances and other monetary assets or liabilities denominated in currencies other than the U.S. dollar. The Company has \$1.9 million of derivative assets recorded as prepaid and other current assets and \$0.1 million of derivative liabilities recorded as other accrued liabilities in the unaudited Condensed Consolidated Balance Sheets at June 30, 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 (EUR) and the Korean Won (KRW).

As of June 30, 2013, the Company had notional amounts of EUR 67.0 million and KRW 2.7 billion of outstanding currency forward contracts entered into to hedge EUR and KRW denominated sales, compared to EUR 20.0 million and KRW 4.4 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 and six months ended June 30, 2013 and 2012 were not significant. Other impacts of derivative instruments designated as cash flow hedges were not significant for the three and six months ended June 30, 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 EUR, the British Pound (GBP), the Swiss Franc (CHF), Japanese Yen (JPY) and the KRW. Accordingly, any gains or losses from changes in the fair value of the forward contracts are recorded in interest and other income (expense), net. The gains and losses on these forward contracts generally offset the gains and losses associated with the underlying assets and liabilities, which are also recorded in interest and other income (expense), net. The duration of the forward contracts for hedging the Company's balance sheet exposure is approximately one month.



**Table of Contents**

Derivative instruments used to hedge against balance sheet foreign currency exposures at the end of each period were as follows (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Recognized gains (losses) in interest and other income (expense), net	\$ (0.2)	\$ 1.1	\$ 0.8	\$ 0.6
Foreign exchange gains (losses) related to re-measurement	\$	\$ (1.1)	\$ (1.3)	\$ (0.6)

The notional amounts for derivative instruments provide one measure of the transaction volume outstanding as of June 30, 2013 and December 31, 2012, respectively. Total gross notional amounts for outstanding derivatives (recorded at fair value) at the end of each period were as follows (in millions):

	June 30, 2013	December 31, 2012
European Euro	30.0	37.6
Korean Won	9,691.1	4,600.0
British Pound	4.3	5.4
Swiss Franc	0.5	1.0
Japanese Yen	80.0	

**NOTE 4. BALANCE SHEET DETAILS****Inventories**

The following table summarizes the Company's inventories as of June 30, 2013 and December 31, 2012 (in millions):

	June 30, 2013	December 31, 2012
<b><u>Inventories:</u></b>		
Raw materials	\$ 50.2	\$ 41.2
Work-in-process	6.4	4.4
Finished goods	112.7	75.9
<b>Total inventories</b>	<b>\$ 169.3</b>	<b>\$ 121.5</b>

**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 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. 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

## Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

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 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



---

**Table of Contents**

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.

On April 26, 2013, a purported class action lawsuit entitled *Abrams v. Intuitive Surgical et al.*, No. 5-13-cv-1920, was filed against nine of the Company's current and former officers and directors in the United States District Court for the Northern District of California. A word-for-word identical complaint, entitled *Adel v. Intuitive Surgical, et al.*, No. 3:13-cv-2365, was filed in the same court against the same defendants on May 24, 2013. The lawsuits seek unspecified damages on behalf of a putative class of persons who purchased or otherwise acquired the Company's common stock between October 19, 2011 and April 18, 2013. The complaints allege 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. By agreement, the two cases will be assigned to the same judge and will proceed together. Motions seeking appointment as lead plaintiff in the *Abrams* were filed by two parties on June 25, 2013. One of those motions was subsequently withdrawn. A hearing on the remaining motion is scheduled to be heard November 22, 2013. By agreement with the Plaintiff in the *Abrams* action, no response to the complaint is required until 30 days after a lead plaintiff is selected by the Court and that lead plaintiff files a consolidated complaint (or informs the Company that it has chosen to proceed with the complaint already on file). The *Adel* complaint has not been served and no response is currently required.

The Company is currently named as a defendant in approximately 33 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 Company's part 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 pre-trial activity.

In February 2011, the Company was sued in a product liability action that had originally been filed in Washington State Superior Court for Kitsap County against the healthcare providers and hospital involved in the plaintiff's decedent's surgery (*Josette Taylor, as Personal Representative of the Estate of Fred E. Taylor, deceased; and on behalf of the Estate of Fred E. Taylor v. Intuitive Surgical, Inc.*, No. 09-2-03136-5). In *Taylor*, plaintiff asserted 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 plaintiff in *Taylor* asserted 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 sought 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. On May 23, 2013, the jury returned a defense verdict, finding that the Company was not negligent. Plaintiff has filed a notice of appeal.

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 portion of them. In an effort to provide an orderly process for evaluating claims before they result in costly litigation, the Company has entered into tolling agreements with certain plaintiffs' 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 file lawsuits, nor is able at this time to estimate the financial implications of their claims or predict the final disposition of such claims. The Company intends to vigorously defend lawsuits that are ultimately filed.

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 an estimate of the possible loss or range of losses cannot be determined. 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 future results of operations.

The Company is also a party to various other legal actions that have arisen 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.



**Table of Contents****NOTE 6. STOCKHOLDERS EQUITY****Share Repurchase Program**

The following table provides the share repurchase activities during the three and six months ended June 30, 2013 and 2012 (in millions, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Shares repurchased	0.5	0.1	0.8	0.1
Average price per share	\$ 493.49	\$ 523.06	\$ 491.28	\$ 523.06
Value of shares repurchased	\$ 269.6	\$ 15.2	\$ 415.4	\$ 15.2

On March 20, 2013, the Company's Board of Directors (the Board) authorized an additional \$1.0 billion of stock repurchases. As of June 30, 2013, the remaining amount of share repurchases authorized by the Board was approximately \$0.9 billion.

**Accumulated Other Comprehensive Income**

The components of accumulated other comprehensive income, net of tax, for the three and six months ended June 30, 2013 and 2012 are as follows (in millions):

	Three Months Ended June 30, 2013			
	Unrealized			
	Gains (Losses) on Hedge Instruments	Gains (Losses) on Available-for- Sale Securities	Foreign Currency Translation Gains (Losses)	Total
Beginning balance	\$ 0.8	\$ 7.3	\$	\$ 8.1
Other comprehensive income before reclassifications	0.2	(10.2)	0.1	(9.9)
Reclassified from accumulated other comprehensive income	(0.4)	0.1		(0.3)
Net current-period other comprehensive income	(0.2)	(10.1)	0.1	(10.2)
Ending balance	\$ 0.6	\$ (2.8)	\$ 0.1	\$ (2.1)

	Three Months Ended June 30, 2012			
	Unrealized			
	Gains (Losses) on Hedge Instruments	Gains (Losses) on Available-for- Sale Securities	Foreign Currency Translation Gains (Losses)	Total
Beginning balance	\$ (0.8)	\$ 2.2	\$ 0.1	\$ 1.5
Other comprehensive income before reclassifications	1.8	1.1	(0.1)	2.8
Reclassified from accumulated other comprehensive income	(0.7)			(0.7)
Net current-period other comprehensive income	1.1	1.1	(0.1)	2.1
Ending balance	\$ 0.3	\$ 3.3	\$	\$ 3.6



**Table of Contents**

	Six Months Ended June 30, 2013			
	Gains (Losses) on Hedge Instruments	Unrealized Gains (Losses) on Available-for- Sale Securities	Foreign Currency Translation Gains (Losses)	Total
Beginning balance	\$	\$ 6.2	\$ 0.4	\$ 6.6
Other comprehensive income before reclassifications	1.6	(9.3)	(0.3)	(8.0)
Reclassified from accumulated other comprehensive income	(1.0)	0.3		(0.7)
Net current-period other comprehensive income	0.6	(9.0)	(0.3)	(8.7)
Ending balance	\$ 0.6	\$ (2.8)	\$ 0.1	\$ (2.1)

	Six Months Ended June 30, 2012			
	Gains (Losses) on Hedge Instruments	Unrealized Gains (Losses) on Available-for- Sale Securities	Foreign Currency Translation Gains (Losses)	Total
Beginning balance	\$	\$ 1.1	\$ (0.2)	\$ 0.9
Other comprehensive income before reclassifications	0.7	2.0	0.2	2.9
Reclassified from accumulated other comprehensive income	(0.4)	0.2		(0.2)
Net current-period other comprehensive income	0.3	2.2	0.2	2.7
Ending balance	\$ 0.3	\$ 3.3	\$	\$ 3.6

**NOTE 7. SHARE-BASED COMPENSATION****Stock Option Plans***2009 Employment Commencement Incentive Plan*

In January 2013, the Board amended and restated the 2009 Employment Commencement Incentive Plan ( 2009 Plan ) to provide for an increase in the number of shares of common stock authorized for issuance pursuant to awards granted under the 2009 Plan from 730,000 to 855,000. In May 2013, the Board amended and restated the 2009 Plan to provide for an additional increase in the number of shares of common stock authorized for issuance pursuant to awards granted under the 2009 Plan from 855,000 to 1,155,000.

*2010 Incentive Award Plan*

On April 25, 2013, the Shareholders approved an amended and restated 2010 Incentive Award Plan ( 2010 Plan ) to provide for an increase in the number of shares of common stock reserved for issuance from 3,650,000 to 4,850,000.

A summary of stock option activity under all stock plans for the six months ended June 30, 2013 is presented as follows (in millions, except per share amounts):

	Stock Options Outstanding		
	Shares Available for Grant	Number Outstanding	Weighted Average Exercise Price Per Share
Balance at December 31, 2012	1.7	4.8	\$ 340.83

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Options authorized	1.6			
Options granted	(0.8)	0.8		554.50
Options exercised		(0.4)		256.00
Options forfeited/expired	0.1	(0.1)		447.18
Balance at June 30, 2013	2.6	5.1	\$	377.59

As of June 30, 2013, options to purchase an aggregate of 2.7 million shares of common stock were exercisable at a weighted-average price of \$292.39 per share.

**Table of Contents****Employee Stock Purchase Plan**

Under the Employee Stock Purchase Plan ( ESPP ), employees purchased approximately 0.1 million shares for \$16.4 million and 0.1 million shares for \$13.9 million during the six months ended June 30, 2013 and 2012, respectively. There was no new ESPP offering during the three months ended June 30, 2013 and 2012.

**Share-based Compensation**

The following table summarizes share-based compensation expense for the three and six months ended June 30, 2013 and 2012 (in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Cost of sales - products	\$ 4.1	\$ 3.1	\$ 8.0	\$ 6.2
Cost of sales - services	3.0	2.7	5.9	5.5
Total cost of sales	7.1	5.8	13.9	11.7
Selling, general and administrative	23.0	20.3	46.0	41.5
Research and development	8.6	7.2	17.0	14.5
Share-based compensation expense before income taxes	38.7	33.3	76.9	67.7
Income tax benefit	12.4	10.1	24.6	21.1
Share-based compensation expense after income taxes	\$ 26.3	\$ 23.2	\$ 52.3	\$ 46.6

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 June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Stock Options</b>				
Average risk free interest rate	0.8%	0.8%	0.9%	0.8%
Average expected term (in years)	4.4	4.3	4.6	4.5
Average expected volatility	31%	32%	29%	32%
Weighted average fair value at grant date	\$ 132.88	\$ 149.90	\$ 141.68	\$ 143.50
<b>ESPP</b>				
Average risk free interest rate			0.2%	0.2%
Average expected term (in years)			1.3	1.3
Average expected volatility			33%	32%
Weighted average fair value at grant date			\$ 170.51	\$ 133.75

**NOTE 8. INCOME TAXES**

The effective income tax rate for the three month periods ended June 30, 2013 and 2012 were 28.6% and 32.4%, respectively. The effective income tax rate for the six month periods ended June 30, 2013 and 2012 were 27.2% and 30.0%, respectively. The effective tax rates for 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 income tax provision for the six month period ended June 30, 2013 reflected a discrete net benefit of \$7.5 million related to 2012 federal research and development ( R&D ) credit which was retroactively reinstated during the three month period ended March 31, 2013. No federal R&D credit benefit was recorded in the income tax provision for the three and six month periods ended June 30, 2012. The income tax provision for the six month period ended June 30, 2012 included a discrete benefit of \$8.5 million for previously unrecognized tax benefits, reflecting the

## Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Internal Revenue Service guidance issued in the three month period ended March 31, 2012. The Company intends to indefinitely reinvest outside the U.S. all of its undistributed foreign earnings that were not previously subject to U.S. tax.

As of June 30, 2013, the Company had total gross unrecognized tax benefits of approximately \$102.2 million compared with approximately \$88.0 million as of December 31, 2012, representing an increase of approximately \$14.2 million for the six months ended June 30, 2013. Of the total gross unrecognized tax benefits, \$97.9 million and \$83.8 million as of June 30, 2013 and



**Table of Contents**

December 31, 2012, respectively, if recognized, would reduce the effective tax rate in the period of recognition. Gross interest related to unrecognized tax benefit accrued was approximately \$4.3 million and \$3.2 million, respectively, as of June 30, 2013 and December 31, 2012, representing an increase of \$1.1 million.

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

**NOTE 9. NET INCOME PER SHARE**

The following table presents the computation of basic and diluted net income per share for the three and six months ended June 30, 2013 and 2012 (in millions, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Numerator:</b>				
Net income	\$ 159.1	\$ 154.9	\$ 348.0	\$ 298.4
<b>Denominator:</b>				
Weighted-average shares outstanding used in basic calculation	39.9	39.9	40.1	39.7
Add: Dilutive effect of potential common shares	0.9	1.4	1.0	1.4
Weighted-average shares used in computing diluted net income per share	40.8	41.3	41.1	41.1
<b>Net income per share:</b>				
Basic	\$ 3.99	\$ 3.88	\$ 8.68	\$ 7.52
Diluted	\$ 3.90	\$ 3.75	\$ 8.47	\$ 7.26

Employee stock options to purchase approximately 2.1 million and 0.7 million weighted-average shares for the three months ended June 30, 2013 and 2012, respectively, and approximately 1.9 million and 0.6 million weighted-average shares for the six months ended June 30, 2013 and 2012, 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 anti-dilutive.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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

This management's discussion and analysis of financial condition as of June 30, 2013 and results of operations for the three and six months ended June 30, 2013 and 2012 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, 2012.

This report contains forward-looking statements. 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, words and expressions 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; decreases in hospital admissions and actions by payers to limit or manage surgical procedures; 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; product liability and other litigation claims; adverse publicity regarding the Company and the safety of our products and adequacy of training; our ability to expand into foreign markets; and other risk factors. Readers are cautioned not to place undue reliance on these forward-looking statements, which 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, 2012 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 publicly update or release any revisions to these forward-looking statements, except as required by law.

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, *EndoWrist*® Stapler 45, Single-Site®, *Firefly*®, *InSite* and *da Vinci*® Connect are trademarks of Intuitive Surgical, Inc.

**Overview**

Intuitive designs, manufactures and markets *da Vinci* Surgical Systems and related instruments and accessories, which taken together, are advanced surgical systems that represent a new generation of surgery. This new generation of surgery, which we call *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 enables surgeons to extend the benefits of MIS to many patients who would otherwise undergo a more invasive surgery by using computational, robotic and imaging technologies to overcome many of the limitations of conventional MIS. Surgeons using the *da Vinci* system operate while seated comfortably at a console viewing a Three Dimensional (3-D), High Definition (HD) image of the surgical field. This immersive visualization connects surgeons to the surgical field and their instruments. While seated at the console, the surgeon manipulates instrument controls in a natural manner, similar to the more intuitive open surgery technique. Our technology is designed to provide surgeons with a range of motion in the surgical field analogous to the motions of a human wrist, while filtering out the tremor inherent in a surgeon's hand. In designing our products, we focus on making our technology easy to use.

Our products fall into four broad categories: *da Vinci* Surgical Systems, *InSite* and *Firefly* Fluorescence imaging systems (*Firefly*), instruments and accessories (e.g., *EndoWrist*, *EndoWrist One*, *EndoWrist One* Vessel Sealer, *da Vinci* Single-Site and *EndoWrist* Stapler 45) and training technologies. We have commercialized three generations of *da Vinci* Surgical Systems; the first is our *da*



## **Table of Contents**

*Vinci standard* Surgical System, first commercialized in 1999, the second is our *da Vinci S* Surgical System, commercialized in 2006, and the third and most current is our *da Vinci Si* Surgical System, commercialized in 2009. Systems include a surgeon's console (or consoles), imaging electronics, a patient-side cart and computational hardware and software. In the first quarter of 2011, we launched our *Firefly* product for use with the *da Vinci Si* Surgical System. This 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. 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. Instruments and accessories are used with systems to allow surgeons the flexibility in choosing the types of tools needed in a particular surgery. In the fourth quarter of 2011, we introduced our Single-Site instruments in the U.S. for use in cholecystectomy procedures utilizing the *da Vinci Si* Surgical System. During the first quarter of 2013, Single-Site instruments were FDA cleared in the U.S. for use in benign hysterectomies and salpingo oophorectomies. Single-Site instruments enable surgeons to perform surgery through a single port via the patient's belly button, resulting in virtually scarless patient outcomes. Single-Site instruments were Conformité Européenne (CE) marked and introduced in Europe in the first quarter of 2011. Training technologies include our recently developed *da Vinci* Connect remote case observation and mentoring tool, our *da Vinci* Skills Simulator and our dual console for use in surgeon proctoring and collaborative surgery.

We model patient value as equal to procedure efficacy / invasiveness. In this equation procedure efficacy is defined as a measure of the success of the surgery in resolving the underlying disease and invasiveness is defined as a measure of patient pain and disruption of regular activities. When the patient value of a *da Vinci* procedure is greater than that of alternative treatment options, patients may benefit from seeking out surgeons and hospitals that offer *da Vinci* surgery, which potentially could result in a local market share shift. 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.

### **Procedures - Historical Summary**

#### *Worldwide Procedures*

The adoption of *da Vinci* surgery has the potential to grow for those procedures that offer greater patient value than non *da Vinci* alternatives. We focus our organization and investments on developing, marketing and training for those products and procedures where *da Vinci* can bring significant patient value relative to alternative treatment options. In 2012, *da Vinci* was used primarily in gynecology, urology, general surgery, cardiothoracic surgery and head and neck surgery. Target procedures in gynecology include *da Vinci* Hysterectomy (dVH), sacrocolpopexy, myomectomy, and endometriosis resection. Target procedures in urology include *da Vinci* Prostatectomy (dVP), partial nephrectomy and pyeloplasty. Target procedures in general surgery include Single-Site Cholecystectomy and colorectal procedures. In cardiothoracic surgery, target procedures include *da Vinci* Lobectomy and *da Vinci* Mitral Valve Repair. In head and neck surgery, target procedures include *da Vinci* Trans-oral Robotic-Assisted Surgery (TORS) for throat and base of tongue cancers.

In 2012, approximately 450,000 surgical procedures were performed with the *da Vinci* Surgical System, compared to approximately 360,000 and 278,000 procedures performed in 2011 and 2010, respectively. The growth in our overall procedure volume in 2012 was driven by the growth in U.S. gynecologic procedures, U.S. general surgery procedures, and dVP procedures outside of the U.S., partially offset by a decline of approximately 15% in U.S. dVP procedures compared to 2011.

#### *U.S. Procedures*

Overall U.S. procedure volume grew to approximately 367,000 in 2012, compared to approximately 292,000 in 2011 and 228,000 in 2010.

Gynecology is our largest U.S. surgical specialty. Overall U.S. gynecology procedure volume grew from approximately 123,000 cases in 2010 to approximately 170,000 in 2011 and to approximately 222,000 in 2012. The growth was driven by adoption of dVH, our highest volume procedure, and other gynecologic procedures, including sacrocolpopexy, endometriosis resection, and myomectomy. U.S. dVH procedure volume grew from approximately 140,000 cases in 2011 to approximately 176,000 cases in 2012, of which approximately 38,000 were for the treatment of cancer and approximately 138,000 were related to benign conditions. We estimate the total annual U.S. addressable robotic hysterectomy market to consist of those procedures previously performed in open surgery, which we estimate to be approximately 300,000 to 350,000 cases, of which approximately 50,000 are for cancer.

Urology is our second largest surgical specialty. U.S. urology procedure volume was approximately 88,000 in 2012, compared to approximately 93,000 in 2011 and 85,000 in 2010. The 2012 decline was driven by lower dVP procedure volume. We consider dVP to be the standard of care for the surgical treatment of prostate cancer in the U.S. About 62,000 dVPs were performed in 2012, compared to 73,000 in 2011 and 68,000 in 2010. The approximately 15% reduction in 2012 dVP procedures in the U.S. reflects pressures from reduced levels of prostate-specific antigen (PSA) testing and increased use of non-surgical disease management. Other (non-dVP) urology procedures, including partial and full

nephrectomy, increased approximately 27% in 2012 to 26,000 cases.

---

## **Table of Contents**

General surgery is our third largest and fastest growing specialty. Overall U.S. general surgery procedure volume grew from approximately 10,000 cases in 2010 to approximately 15,000 in 2011 and to approximately 42,000 in 2012. General surgery growth was led by an increase in cholecystectomy and colorectal procedures. *da Vinci* Single-Site instrumentation was FDA cleared for U.S. cholecystectomies in December 2011.

### *International Procedures*

Overall international procedure volume grew to approximately 83,000 in 2012, compared to approximately 68,000 in 2011 and 50,000 in 2010. dVP accounted for the majority of international procedures, having grown from about 30,000 in 2010 to 40,000 in 2011 and to 47,000 in 2012. The overall international procedure growth rate of approximately 22% in 2012 was lower than the 36% growth rate in 2011, primarily due to lower European growth rates resulting from the implementation of austerity measures by European governments, reduced levels of PSA testing, increased use of non-surgical disease management and other Company specific matters.

### **Business Model**

We generate revenue from both the initial capital sales of *da Vinci* Surgical Systems as well as recurring revenue, derived from sales of instruments, accessories and service. The *da Vinci* Surgical System generally sells for between \$1.0 million and \$2.3 million, depending upon configuration and geography, and represents a significant capital equipment investment for our customers. We generate recurring revenue as our customers consume our *EndoWrist* instruments and accessory products used 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. Also, we generate recurring revenue from ongoing system service. Typically, we enter into service contracts at the time systems are sold at an annual rate of approximately \$100,000 to \$170,000 per year, depending upon the configuration of the underlying system. These service contracts have generally been renewed at the end of the initial contractual service periods.

Recurring revenue has grown at a rate equal to or faster than the rate of growth of system revenue. Recurring revenue increased from \$979.5 million, or 56% of total revenue in 2011, to \$1,245.9 million, or 57% of total revenue, in 2012. Recurring revenue increased from \$595.7 million, or 58% of total revenue, for the six months ended June 30, 2012 to \$718.1 million, or 60% of total revenue, for the six months ended June 30, 2013. 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 slower systems growth in the second quarter of 2013. 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 2,799 at June 30, 2013, compared with 2,585 at December 31, 2012 and 2,341 at June 30, 2012.

We provide our products through a direct sales organization in the U.S. and in Europe, excluding Spain, Italy, Greece and Eastern European countries. In January 2012, we acquired our Korean distributor and began selling directly to Korean customers. In January 2013, we began to provide our products through a direct sales organization in the Czech Republic, Slovakia, and Hungary, whereas prior to 2013, these markets were served by a distributor. In the remainder of our world markets, we provide our products through distributors.

### **Regulatory Activities**

We believe that we have obtained the clearances required to market our multiport products to our targeted surgical specialties within the U.S. and most of Europe. As we make additions to target procedures and introduce new products, we will continue to seek necessary clearances. In February 2013, we received FDA clearance to market our Single-Site instruments for benign hysterectomy and salpingo oophorectomy procedures. FDA clearance for Single-Site Cholecystectomy was received in December 2011. 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.

A recent FDA inspection of the Company's facilities occurred in April-May 2013 and the FDA issued a Form FDA 483 listing four objectionable observations. These four observations relate to the reporting of field actions, information which is to be included on reports of field actions, lack of a written procedure for changes to certain product claims, and design input documentation. We responded to each observation with corrective actions during the course of the inspection and have provided additional evidence of corrective actions after the inspection to the FDA. In addition, the FDA collected in electronic form, samples of all advertising and promotional material for review. The FDA issued a warning letter, dated July 16, 2013, related to their observations and asked for additional corrective actions and indicated their intent to perform a follow-up inspection. We believe that the FDA's observations are addressable and we are in the process of correcting them. However, we cannot assure that, upon re-inspection, the FDA will find that our corrective actions are appropriate or that they have been adequately implemented. We also cannot assure that the FDA will not find other observations. The FDA previously inspected our Sunnyvale, CA headquarters in January 2012 and did not issue a Form FDA 483 as a result of this inspection.

## Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

In November 2009, we received Shonin approval from the Japanese Ministry of Health, Labor, and Welfare ( MHLW ) for our *da Vinci S* Surgical System in Japan. Until April 2012, we had partnered with the experienced regulatory team from Johnson & Johnson

---

## **Table of Contents**

K.K. Medical Company ( JJKK ) to assist in navigating the Japanese regulatory process. In April 2012, the Marketing Authorization Application for *da Vinci* products was transferred to Intuitive Surgical Japan from JJKK, 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 for marketing, selling, and servicing our products in Japan. Effective April 2012, we obtained national reimbursement for the dVP procedures in Japan, our only reimbursed procedure to date. In October 2012, we obtained MHLW approval for *da Vinci Si* Surgical Systems 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.

### **First Half of 2013 Business Events and Trends**

#### **Environment and Demand for Our Products**

During the first half of 2013, there have been a number of factors that have resulted in slower than expected growth in U.S. benign gynecologic procedures. The impact of each factor on procedure volumes is difficult to quantify, but include decreased hospital admissions as reported by certain customers; quality notifications issued by us and the recent media discussed below; and, the difficulty associated with consolidating geographically dispersed patients into established robotic surgery programs as benign hysterectomy passes through the midpoint of its adoption. We believe that reduced procedure growth coupled with the economic hardship that reduced admissions creates, adversely impacted system purchases in the second quarter of 2013. We expect growth in benign procedures to continue at a level below 2012 and could decline further depending on changes in hospital admissions, payer behavior, the impact of the Affordable Care Act and other factors. Demand for *da Vinci* systems fluctuates quarter to quarter based upon procedure growth, and changing economic and geopolitical factors.

The European credit and sovereign debt issues have slowed capital sales and curtailed procedure growth during 2012 and through the first half of 2013. European uncertainties could adversely impact demand for our products globally.

#### **Recent Media and Lawsuits**

During the first half of 2013, various print, television, and internet media have released pieces questioning the patient safety and efficacy associated with *da Vinci* Surgery, the cost of *da Vinci* Surgery relative to other disease management methods, and the adequacy of surgeon training. In addition, as further described below in Part II, Item 1, Legal Proceedings, we are currently named as a defendant in approximately 33 individual product liability lawsuits. 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, and we have seen a substantial increase in these claims. We believe that *da Vinci* Surgery continues to be a safe and effective surgical method, as supported by a substantial and growing number of scientific studies and peer reviewed papers. We also believe that the training we provide to surgeons help to ensure that they are able to operate our systems with the requisite skill and expertise. However, the recent negative media may have and could continue to delay or adversely impact procedure adoption, system sales, and our revenue growth in future periods.

#### **Procedures**

*Overall.* During the first half of 2013, total *da Vinci* procedures grew approximately 18% compared with the first half of 2012, driven by growth in general surgery and gynecology procedures in the U.S. and international urology procedures, partially offset by an approximately 8% reduction in dVP procedures in the U.S.

*dVP.* We believe the U.S. Preventive Services Task Force recommendation against PSA screening, as well as changes in treatment pattern for low risk prostate cancer away from definitive treatment, have led to a decline in our dVP business. We estimate that dVP procedures in the U.S. decreased approximately 8% in the first half of 2013 compared with the same period in 2012. Second quarter 2013 U.S. dVP procedures were approximately 2% lower than the first quarter of 2013. These treatment patterns have also impacted our European dVP procedure volumes. dVP is at earlier market penetration stages in the European markets, therefore, we are unable to precisely estimate the extent to which these recommendations and treatment pattern changes may have been adopted by governments or clinicians within non-U.S. jurisdictions.

*Benign Gynecology Procedure Adoption Trends.* During the first half of 2013, we experienced lower growth rates for U.S. benign gynecologic procedures than in prior years. The slowdown of growth rates in the number of U.S. benign hysterectomy procedures being performed reflected a number of factors including, but not limited to, apparent pressure on benign gynecology hospital admissions and a trend by payers toward encouraging conservative disease management and treatment in outpatient settings. We still have a significant remaining market opportunity in benign gynecologic procedures since a large number are still done via open technique. However, as we penetrate more deeply into benign gynecologic procedures, our pace of capturing or consolidating the remaining market is progressing at a slower rate.



## Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

*Monopolar Curved Scissors Field Action.* During early May 2013, we issued a field notice informing customers of the potential for micro-crack formations in certain of our *EndoWrist* Monopolar Curved Scissors ( MCS ). We decided to stop shipment of these versions until a replacement product was made available. However, as the risk of injury to patients from the recalled product was

## **Table of Contents**

extremely low, customers were notified that they could continue to use the recalled product; which most did. To date, we have no confirmed evidence of patient injury attributable to this issue. The replacement MCS product began shipping on May 31, 2013. We do not believe that this field action materially impacted second quarter 2013 procedure volume and customer returns of the recalled product have not been material.

*Procedure Seasonality.* The majority of *da Vinci* procedures performed are now for benign conditions, most notably benign hysterectomies. The proportion of these benign procedures is growing in relation to the total number of procedures performed. Hysterectomies for benign conditions and other short-term elective procedures tend to be more seasonal than cancer operations and surgeries for other life threatening conditions. Seasonality for these benign procedures results in higher fourth quarter procedure volume when more patients have met annual deductibles and lower first quarter procedure volume when deductibles are reset. Third quarter activity is also slower given vacation periods, particularly in Europe. As we achieve deeper penetration in certain procedures, seasonality has a more substantive impact on our business.

## **New Product Introductions**

***EndoWrist Stapler 45.*** In October 2012, we received FDA clearance for the *EndoWrist Stapler 45* instrument with Blue (3.5mm open staple height) and Green (4.3mm open staple height) 45 mm reloads. The *EndoWrist Stapler 45* is a wristed, stapling instrument intended for resection, transection and/or creation of anastomoses in general, gynecologic and urologic surgery. This instrument enables operators of the *da Vinci Si* to precisely position and fire the *EndoWrist Stapler 45*. We expect its initial surgical use to be directed towards colorectal procedures. During the first half of 2013, initial use of the *EndoWrist Stapler 45* occurred in a limited number of customers. We expect to expand slowly to a broader set of customers later in 2013. Although our first customer experiences have been positive, we are in the early stages of selling *EndoWrist Stapler 45* and we are not able to predict the extent to which the instrument may be adopted.

## **Second Quarter 2013 Financial Highlights**

Total revenue increased 8% to \$578.5 million during the three months ended June 30, 2013 from \$536.5 million during the three months ended June 30, 2012.

The total number of *da Vinci* procedures performed during the three months ended June 30, 2013 was up approximately 18% compared with the three months ended June 30, 2012.

Instruments and accessories revenue increased 18% to \$264.5 million during the three months ended June 30, 2013 from \$223.7 million during the three months ended June 30, 2012.

Recurring revenue increased 18% to \$362.6 million during the three months ended June 30, 2013, representing 63% of total revenue, from \$307.1 million during the three months ended June 30, 2012, representing 57% of total revenue.

We sold 143 *da Vinci* Surgical Systems during the three months ended June 30, 2013, compared with 150 during the three months ended June 30, 2012.

System revenue decreased 6% to \$215.9 million during the three months ended June 30, 2013 from \$229.4 million during the three months ended June 30, 2012.

As of June 30, 2013, we had a *da Vinci* Surgical System installed base of 2,799 systems, consisting of 2,001 in the U.S., 442 in Europe, and 356 in the rest of the world.

## Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Operating income decreased 3% to \$218.5 million during the three months ended June 30, 2013 compared with \$225.3 million during the three months ended June 30, 2012. Operating income included \$38.7 million and \$33.3 million during the three months ended June 30, 2013 and 2012, respectively, of share-based compensation expense related to employee stock programs.

As of June 30, 2013, we had \$3.0 billion in cash, cash equivalents and investments. Cash, cash equivalents and investments decreased by \$88.8 million during the three months ended June 30, 2013 primarily driven by cash used in repurchasing \$269.6 million of stock, partially offset by cash provided from operations.

**Table of Contents****Results of Operations**

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

	Three Months Ended June 30,				Six Months Ended June 30,			
	2013	% of total revenue	2012	% of total revenue	2013	% of total revenue	2012	% of total revenue
<b>Revenue:</b>								
Product	\$ 480.4	83%	\$ 453.1	84%	\$ 997.4	84%	\$ 867.5	84%
Service	98.1	17%	83.4	16%	192.5	16%	164.2	16%
Total revenue	578.5	100%	536.5	100%	1,189.9	100%	1,031.7	100%
<b>Cost of revenue:</b>								
Product	140.9	24%	122.9	23%	287.2	24%	234.6	23%
Service	32.4	6%	27.2	5%	63.2	5%	54.8	5%
Total cost of revenue	173.3	30%	150.1	28%	350.4	29%	289.4	28%
Product gross profit	339.5	59%	330.2	61%	710.2	60%	632.9	61%
Service gross profit	65.7	11%	56.2	11%	129.3	11%	109.4	11%
Gross profit	405.2	70%	386.4	72%	839.5	71%	742.3	72%
<b>Operating expenses:</b>								
Selling, general and administrative	145.5	25%	120.9	23%	287.0	24%	245.1	24%
Research and development	41.2	7%	40.2	7%	82.8	7%	78.6	8%
Total operating expenses	186.7	32%	161.1	30%	369.8	31%	323.7	32%
Income from operations	218.5	38%	225.3	42%	469.7	39%	418.6	40%
Interest and other income (expense), net	4.3	1%	4.0	1%	8.6	1%	7.8	1%
Income before taxes	222.8	39%	229.3	43%	478.3	40%	426.4	41%
Income tax expense	63.7	11%	74.4	14%	130.3	11%	128.0	12%
Net income	\$ 159.1	28%	\$ 154.9	29%	\$ 348.0	29%	\$ 298.4	29%

**Total Revenue**

Total revenue was \$578.5 million for the three months ended June 30, 2013, compared with \$536.5 million for the three months ended June 30, 2012. For the six months ended June 30, 2013, total revenue increased to \$1,189.9 million from \$1,031.7 million for the six months ended June 30, 2012. Total revenue growth for these periods was driven by the continued adoption of *da Vinci* surgery, resulting largely from the growth in U.S. general surgery procedures, including cholecystectomy and colorectal procedures, and gynecologic procedures, including dVH, sacrocolpopexy, endometriosis resection, and myomectomy, and the growth in dVP procedures outside the U.S., partially offset by a decline of approximately 8% in dVP procedures in the U.S. The total revenue growth was also driven by higher system sales into the Japanese and European markets. 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.

## Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Revenue within the U.S. accounted for 73% and 74% of total revenue for the three and six months ended June 30, 2013, compared to 81% and 80% of total revenue for the three and six months ended June 30, 2012, respectively. Our domestic revenue has accounted for the large majority of total revenue primarily due to rapid procedure adoption in the U.S. driven by the ability of patients to choose their provider and method of treatment. For the three and six months ended June 30, 2013, international revenue grew at a faster rate than U.S. revenue primarily due to higher system sales in the Japanese and European markets along with a decline in system sales in the U.S. market.

**Table of Contents**

The following table summarizes our revenue and *da Vinci* Surgical System unit sales for the three and six months ended June 30, 2013 and 2012 (in millions, except percentages and unit sales):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Revenue</b>				
Instruments and accessories	\$ 264.5	\$ 223.7	\$ 525.6	\$ 431.5
Systems	215.9	229.4	471.8	436.0
Total product revenue	480.4	453.1	997.4	867.5
Services	98.1	83.4	192.5	164.2
Total revenue	\$ 578.5	\$ 536.5	\$ 1,189.9	\$ 1,031.7
Recurring revenue	\$ 362.6	\$ 307.1	\$ 718.1	\$ 595.7
% of total revenue	63%	57%	60%	58%
Domestic	\$ 420.5	\$ 435.4	\$ 878.6	\$ 826.1
International	158.0	101.1	311.3	205.6
Total revenue	\$ 578.5	\$ 536.5	\$ 1,189.9	\$ 1,031.7
% of Revenue - Domestic	73%	81%	74%	80%
% of Revenue - International	27%	19%	26%	20%
<b>Unit Sales by Region:</b>				
Domestic Unit Sales	90	124	205	229
International Unit Sales	53	26	102	61
Total Unit Sales	143	150	307	290
<b>Unit Sales by Model:</b>				
<i>da Vinci Si-e</i> - Single console Unit Sales (3 arm)	2	6	7	7
<i>da Vinci Si</i> - Single console Unit Sales (4 arm)	111	108	220	214
<i>da Vinci Si</i> - Dual console Unit Sales	27	28	75	53
Total <i>da Vinci Si</i> Unit Sales	140	142	302	274
<i>da Vinci S</i> Unit Sales	3	8	5	16
Total Unit Sales	143	150	307	290
<b>Unit Sales involving System Trade-ins:</b>				
Unit sales trading in <i>da Vinci standard</i> Surgical Systems	4	12	13	31
Unit sales trading in <i>da Vinci S</i> Surgical Systems	39	23	69	50
Total unit sales involving trade-ins	43	35	82	81
Unit Sales not trading in any systems	100	115	225	209
Total Unit Sales	143	150	307	290

**Product Revenue**

## Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Product revenue was \$480.4 million for the three months ended June 30, 2013 compared with \$453.1 million for the three months ended June 30, 2012.

Instruments and accessories revenue increased 18% to \$264.5 million for the three months ended June 30, 2013 compared with \$223.7 million for the three months ended June 30, 2012. Instrument and accessory revenue growth was driven by approximately 18% higher *da Vinci* surgical procedure volume and revenue generated from sales of new instrument and accessory products, including Single-Site, *Firefly*, and the *EndoWrist One* Vessel Sealer. Overall procedure growth was driven by the growth in U.S. general surgery procedures, including cholecystectomy and colorectal procedures, and gynecologic procedures, including dVH, sacrocolpopexy, endometriosis resection, and myomectomy, and the growth in dVP procedures outside the U.S., partially offset by a decline of approximately 5% in dVP procedures in the U.S. Gynecologic procedures, particularly dVH for benign conditions, in the U.S., grew at a slower rate than expected, reflecting the factors noted above (See Environment and Demand for Our Products).

**Table of Contents**

Systems revenue decreased to \$215.9 million during the three months ended June 30, 2013 from \$229.4 million during the three months ended June 30, 2012 primarily due to lower *da Vinci* system unit sales. We sold 143 *da Vinci* Surgical Systems during the three months ended June 30, 2013 compared with 150 in the same period last year. The decrease in system unit sales reflects lower second quarter 2013 system sales into U.S. markets, offset by higher international system sales primarily in the Japanese and European markets. During the second quarter of 2013, 90 systems were sold into the U.S., 21 into Europe and 32 into other markets, including 20 systems sold into Japan, compared with 124 systems were sold into the U.S., 13 into Europe and 13 into other markets, including 7 systems sold into Japan during the second quarter of 2012. The decline in U.S. system sales was impacted by several factors, including, among other things, moderating growth in our benign gynecologic procedures and increased economic pressure on hospitals. The *da Vinci* system average selling price ( ASP ) was \$1.50 million for the three months ended June 30, 2013, compared with \$1.53 million for the three months ended June 30, 2012.

Product revenue was \$997.4 million for the six months ended June 30, 2013 compared with \$867.5 million for the six months ended June 30, 2012.

Instruments and accessories revenue increased 22% to \$525.6 million for the six months ended June 30, 2013 compared with \$431.5 million for the six months ended June 30, 2012. Instrument and accessory revenue growth was driven by approximately 18% higher *da Vinci* surgical procedure volume and revenue generated from sales of new instrument and accessory products, including Single-Site, *Firefly*, and the *EndoWrist One Vessel Sealer*. Overall procedure growth was driven by the growth in U.S. general surgery procedures, including cholecystectomy and colorectal procedures, and gynecologic procedures, including dVH, sacrocolpopexy, endometriosis resection, and myomectomy, and the growth in dVP procedures outside of U.S. markets, partially offset by a decline of approximately 5% in dVP procedures in the U.S.

Systems revenue increased to \$471.8 million during the six months ended June 30, 2013 from \$436.0 million during the six months ended June 30, 2012 primarily due to higher *da Vinci* system unit sales. We sold 307 *da Vinci* Surgical Systems during the six months ended June 30, 2013 compared with 290 in the same period last year. The growth in system unit sales reflects higher first half of 2013 system sales into the Japanese and European markets, partially offset by lower U.S. system sales. During the first half of 2013, 205 systems were sold into the U.S., 37 into Europe and 65 into other markets, including 45 systems sold into Japan. The decline in U.S. system sales was impacted by several factors, including, among other things, increased economic pressure on hospitals, which in turn caused some to defer *da Vinci* Surgical System purchases, and moderating growth in our benign gynecologic procedures. During the first half of 2012, 229 systems were sold into the U.S., 27 into Europe and 34 into other markets, including 14 systems sold into Japan. The *da Vinci* system ASP was \$1.52 million for the six months ended June 30, 2013, compared with \$1.50 million for the six months ended June 30, 2012, driven primarily by product mix as system sales during the six months ended June 30, 2013 contained a higher proportion of dual console configurations. During the six months ended June 30, 2013, 69 of the 307 systems sold were dual console systems, compared to 50 of 290 during the six months ended June 30, 2012.

**Service Revenue**

Service revenue increased 18% to \$98.1 million for the three months ended June 30, 2013 compared with \$83.4 million for the three months ended June 30, 2012. Service revenue increased 17% to \$192.5 million for the six months ended June 30, 2013 compared with \$164.2 million for the six months ended June 30, 2012. We typically enter into 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 six months ended June 30, 2013 was primarily driven by a larger installed base of *da Vinci* Surgical Systems producing contract service revenue.

**Gross Profit**

Product gross profit for the three months ended June 30, 2013 increased 3% to \$339.5 million, or 70.7% of product revenue, compared with \$330.2 million, or 72.9% of product revenue, for the three months ended June 30, 2012. Product gross profit for the six months ended June 30, 2013 increased 12% to \$710.2 million, or 71.2% of product revenue, compared with \$632.9 million, or 73.0% of product revenue, for the six months ended June 30, 2012. The higher 2013 product gross profit was driven by higher product revenue. The lower 2013 product gross margin largely reflected the impact of the new U.S. medical device excise tax and lower gross margins earned on recently released instrument and accessory products. Product cost of revenue for the three and six months ended June 30, 2013 included \$6.2 million and \$12.7 million, respectively, related to the U.S. medical device excise tax, which became effective January 1, 2013. Second quarter and first half 2013 product revenue included a higher proportion of recently introduced instrument and accessory products which yield lower gross margin percentages, particularly Single-Site Instruments and the *EndoWrist One Vessel Sealer*. 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 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 June 30, 2013 and 2012 reflected share-based compensation expense of \$4.1 million and \$3.1 million, respectively. Product gross profit for the six months ended June 30, 2013 and 2012 reflected share-based compensation expense of \$8.0 million and \$6.2 million, respectively.





---

## **Table of Contents**

Service gross profit during the three months ended June 30, 2013 was \$65.7 million, or 67.0% of service revenue, compared with \$56.2 million, or 67.4% of service revenue during the three months ended June 30, 2012. Service gross profit during the six months ended June 30, 2013 was \$129.3 million, or 67.2% of service revenue, compared with \$109.4 million, or 66.6% of service revenue during the six months ended June 30, 2012. The higher 2013 service gross profit was driven by a larger installed base of *da Vinci* Surgical Systems. Service gross profit for the three months ended June 30, 2013 and 2012 reflected share-based compensation expense of \$3.0 million and \$2.7 million, respectively. Service gross profit for the six months ended June 30, 2013 and 2012 reflected share-based compensation expense of \$5.9 million and \$5.5 million, respectively.

### **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 June 30, 2013 increased 20% to \$145.5 million, compared with \$120.9 million for the three months ended June 30, 2012. Selling, general and administrative expenses for the six months ended June 30, 2013 increased 17% to \$287.0 million, compared with \$245.1 million for the six months ended June 30, 2012. The increase was primarily due to organizational growth to support our expanding business, particularly in the clinical field sales function, higher legal costs related to pending or threatened litigation, and higher non-cash share-based compensation expense. Share-based compensation expense for the three months ended June 30, 2013 and 2012 was approximately \$23.0 million and \$20.3 million, respectively. Share-based compensation expense for the six months ended June 30, 2013 and 2012 was approximately \$46.0 million and \$41.5 million, respectively.

### **Research and Development Expenses**

Research and development 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 June 30, 2013 increased 2% to \$41.2 million, compared with \$40.2 million for the three months ended June 30, 2012. R&D expenses for the six months ended June 30, 2013 increased 5% to \$82.8 million, compared with \$78.6 million for the six months ended June 30, 2012. The increase was driven by growth in our R&D headcount and higher non-cash share-based compensation expense. Share-based compensation expense for the three months ended June 30, 2013 and 2012 was approximately \$8.6 million and \$7.2 million, respectively. Share-based compensation expense for the six months ended June 30, 2013 and 2012 was approximately \$17.0 million and \$14.5 million, respectively. Amortization expense related to purchased intellectual property during the three months ended June 30, 2013 and 2012 were \$2.6 million and \$3.3 million, respectively. Amortization expense related to purchased intellectual property during the six months ended June 30, 2013 and 2012 were \$5.5 million and \$6.6 million, respectively. We expect to continue to make substantial investments in R&D and anticipate that R&D expense will continue to increase in the future.

### **Interest and Other Income (Expense), Net**

Interest and other income (expense), net for the three months ended June 30, 2013 and 2012 was \$4.3 million and \$4.0 million, respectively. Interest and other income (expense), net for the six months ended June 30, 2013 and 2012 was \$8.6 million and \$7.8 million, respectively. Higher interest and other income, net was driven by higher interest income earned on higher cash, cash equivalents and investment balances.

### **Income Tax Expense**

Income tax expense for the three months ended June 30, 2013 was \$63.7 million, or 28.6% of pre-tax income, compared with \$74.4 million, or 32.4% of pre-tax income for the three months ended June 30, 2012. Income tax expense for the six months ended June 30, 2013 was \$130.3 million, or 27.2% of pre-tax income, compared with \$128.0 million, or 30.0% of pre-tax income for the six months ended June 30, 2012. Our effective tax rates for 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. The income tax provision for the six months ended June 30, 2013 also reflected a discrete net benefit of \$7.5 million related to 2012 federal R&D credit which was retroactively reinstated during the three months ended March 31, 2013. No federal R&D credit benefit was recorded in the income tax provision for the three and six months ended June 30, 2012. The income tax provision for the six months ended June 30, 2012 included a discrete benefit of \$8.5 million for previously unrecognized tax benefits, reflecting the Internal Revenue Service guidance issued in the three months ended March 31, 2012. We intend to indefinitely reinvest outside the U.S. all of our undistributed foreign earnings that were not previously subject to U.S. tax.



**Table of Contents**

As of June 30, 2013, we had total gross unrecognized tax benefits of approximately \$102.2 million compared with approximately \$88.0 million as of December 31, 2012, representing an increase of approximately \$14.2 million for the six months ended June 30, 2013. Of the total gross unrecognized tax benefits, \$97.9 million and \$83.8 million as of June 30, 2013 and December 31, 2012, respectively, if recognized, would reduce the effective tax rate in the period of recognition. Gross interest related to unrecognized tax benefit accrued was approximately \$4.3 million and \$3.2 million, respectively, as of June 30, 2013 and December 31, 2012, representing an increase of \$1.1 million.

We file federal, state and foreign income tax returns in many jurisdictions in the U.S. and internationally. Generally, years before 2009 are closed for most significant jurisdictions, except for California, for which all years since inception remain open due to utilization of net operating losses and R&D credits generated in prior years. 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 we reverse.

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

Our principal source of liquidity is cash provided by operations and proceeds from employee exercise of stock options. Cash and cash equivalents plus short and long-term investments increased from \$2.9 billion at December 31, 2012 to \$3.0 billion at June 30, 2013.

As of June 30, 2013, \$565.9 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.

**Condensed Consolidated Cash Flow Summary (unaudited)**

The following table summarizes our cash flow activities as of June 30, 2013 and 2012 (in millions):

	Six Months Ended June 30,	
	2013	2012
Net cash provided by (used in):		
Operating activities	\$ 447.1	\$ 375.8
Investing activities	(291.0)	(525.1)
Financing activities	(276.8)	168.0
Effect of exchange rates on cash and cash equivalents	(0.3)	(0.1)
Net increase (decrease) in cash and cash equivalents	\$ (121.0)	\$ 18.6

**Operating Activities**

For the six months ended June 30, 2013, cash flow from operations of \$447.1 million exceeded our net income of \$348.0 million for two primary reasons:

1. Our net income included substantial non-cash charges in the form of share-based compensation, amortization of intangible assets, taxes, depreciation and accretion of discounts on investments. These non-cash charges totaled \$113.3 million during the six months ended June 30, 2013.
2. Net working capital, other assets and liabilities increased in the six months ended June 30, 2013 by approximately \$14.2 million. This offset the non-cash charges noted above.

## Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Working capital is comprised primarily of accounts receivable, inventories, deferred revenue and other operating liabilities. Accounts receivable decreased by \$11.7 million during the six months ended June 30, 2013 reflecting timing of our system sales and collections. Inventories increased by \$53.2 million during the six months ended June 30, 2013 primarily due to lower than expected systems sales in the second quarter of 2013, and expanded product offerings. Prepaids and other assets decreased by \$16.1 million during the six months ended June 30, 2013. Deferred revenue increased by \$11.8 million during the six months ended June 30, 2013 due to the increase in the number of installed systems for which service contract exists.

For the six months ended June 30, 2012, cash flow from operations of \$375.8 million exceeded our net income of \$298.4 million for two primary reasons:

1. Our net income included substantial non-cash charges in the form of share-based compensation, amortization of intangible assets, taxes, depreciation and accretion of discounts on investments. These non-cash charges totaled \$104.0 million during the six months ended June 30, 2012.

## **Table of Contents**

2. Net working capital, other assets and liabilities increased during the six months ended June 30, 2012 was approximately \$26.6 million. This offset the non-cash charges noted above.

Working capital is comprised primarily of accounts receivable, inventory, deferred revenue and other operating liabilities. The increase in accounts receivable by \$21.9 million during the six months ended June 30, 2012 is due to increased revenue. The increase in inventory by \$12.2 million during the six months ended June 30, 2012 is due to our business growth and expanded product offerings. Prepaid and other assets increased by \$4.4 million during the six months ended June 30, 2012 primarily due to payment of estimated taxes. Deferred revenue increased by \$12.9 million during the six months ended June 30, 2012 due to the increase in the number of installed systems for which service contract exists.

## **Investing Activities**

Net cash used in investing activities during the six months ended June 30, 2013 consisted of purchases of investments (net of proceeds from sales and maturities of investments) of \$249.3 million and purchase of property and equipment, intellectual property and business of \$41.7 million. Net cash used in investing activities during the six months ended June 30, 2012 consisted of purchases of investments (net of proceeds from sales and maturities of investments) of \$468.7 million and purchase of property and equipment, intellectual property and business of \$56.4 million, including the increase in acquisition-related restricted cash. 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 used in financing activities during the six months ended June 30, 2013 was primarily due to the repurchase of approximately 845,000 shares of our common stock through open market transactions of \$415.4 million, offset by proceeds from stock option exercises and employee stock purchases of \$112.1 million and excess tax benefits from share-based compensation of \$26.5 million. Net cash provided by financing activities during the six months ended June 30, 2012 was primarily due to proceeds from stock option exercises and employee stock purchases of \$138.5 million and excess tax benefits from share-based compensation of \$44.7 million, offset by \$15.2 million used in the repurchase of approximately 29,000 shares of our common stock through open market transactions.

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 h