

INTUITIVE SURGICAL INC
Form 10-Q
April 18, 2008
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 March 31, 2008

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number 000-30713

Intuitive Surgical, Inc.

(Exact name of Registrant as specified in its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

77-0416458
(I.R.S. Employer
Identification Number)

1266 Kifer Road

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Sunnyvale, California 94086

(Address of Principal Executive Offices including 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 reports), and (2) has been subject to such filing requirements for the past 90 days. 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b2 of the Exchange Act.

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 38,704,132 shares of Common Stock, \$0.001 par value per share, outstanding as of April 15, 2008.

Table of Contents

INTUITIVE SURGICAL, INC.

TABLE OF CONTENTS

| | Page No. |
|--|-----------------|
| <u>PART I. FINANCIAL INFORMATION</u> | 3 |
| <u>Item 1. Condensed Consolidated Financial Statements (Unaudited):</u> | 3 |
| <u>Condensed consolidated balance sheets as of March 31, 2008 and December 31, 2007</u> | 3 |
| <u>Condensed consolidated statements of income for the three-month periods ended March 31, 2008 and March 31, 2007</u> | 4 |
| <u>Condensed consolidated statements of cash flows for the three-month periods ended March 31, 2008 and March 31, 2007</u> | 5 |
| <u>Notes to condensed consolidated financial statements</u> | 6 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 14 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 22 |
| <u>Item 4. Controls and Procedures</u> | 23 |
| <u>PART II. OTHER INFORMATION</u> | 24 |
| <u>Item 1. Legal Proceedings</u> | 24 |
| <u>Item 1A. Risk Factors</u> | 24 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 24 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 24 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 24 |
| <u>Item 5. Other Information</u> | 24 |
| <u>Item 6. Exhibits</u> | 24 |
| <u>Signature</u> | 26 |

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****INTUITIVE SURGICAL, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(IN THOUSANDS, EXCEPT PAR VALUE)****(UNAUDITED)**

| | March 31, 2008 | December 31, 2007 (See Note 2) |
|--|---------------------------|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 230,808 | \$ 122,825 |
| Short-term investments | 156,160 | 304,642 |
| Accounts receivable, net | 135,690 | 130,370 |
| Inventory | 38,832 | 32,416 |
| Prepays and other assets | 14,670 | 13,486 |
| Deferred tax assets | 5,852 | 5,852 |
| Total current assets | 582,012 | 609,591 |
| Property, plant and equipment, net | 71,905 | 68,093 |
| Long-term investments | 312,686 | 207,914 |
| Long-term deferred tax assets | 22,458 | 18,725 |
| Intangible assets, net | 21,985 | 23,474 |
| Goodwill | 110,740 | 110,740 |
| Other assets | 1,499 | 1,461 |
| Total assets | \$ 1,123,285 | \$ 1,039,998 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 24,042 | \$ 29,791 |
| Accrued compensation and employee benefits | 18,382 | 30,077 |
| Deferred revenue | 59,248 | 53,817 |
| Other accrued liabilities | 17,592 | 18,085 |
| Total current liabilities | 119,264 | 131,770 |
| Deferred revenue | 883 | 875 |
| Other accrued liabilities | 21,327 | 18,679 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock, 2,500 shares authorized, \$0.001 par value, issuable in series; no shares issued and outstanding as of March 31, 2008 and December 31, 2007, respectively | | |
| Common stock, 100,000 shares authorized, \$0.001 par value, 38,704 and 38,470 shares issued and outstanding as of March 31, 2008 and December 31, 2007, respectively | 39 | 38 |
| Additional paid-in capital | 744,236 | 694,597 |
| Retained earnings | 238,290 | 193,509 |
| Accumulated other comprehensive income (loss) | (754) | 530 |

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

| | | |
|--|--------------|--------------|
| Total stockholders' equity | 981,811 | 888,674 |
| Total liabilities and stockholders' equity | \$ 1,123,285 | \$ 1,039,998 |

See accompanying notes to condensed consolidated financial statements.

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

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2008 | 2007 |
| Net revenue: | | |
| Products | \$ 160,951 | \$ 96,449 |
| Services | 27,243 | 17,780 |
| Total net revenue | 188,194 | 114,229 |
| Cost of net revenue: | | |
| Products | 44,852 | 29,106 |
| Services | 13,535 | 8,615 |
| Total cost of net revenue | 58,387 | 37,721 |
| Gross profit | 129,807 | 76,508 |
| Operating costs and expenses: | | |
| Selling, general, and administrative | 48,634 | 33,945 |
| Research and development | 16,301 | 8,224 |
| Total operating costs and expenses | 64,935 | 42,169 |
| Income from operations | 64,872 | 34,339 |
| Interest and other income, net | 8,541 | 4,608 |
| Income before taxes | 73,413 | 38,947 |
| Income tax expense | 28,632 | 15,145 |
| Net income | \$ 44,781 | \$ 23,802 |
| Net income per share: | | |
| Basic | \$ 1.16 | \$ 0.64 |
| Diluted | \$ 1.12 | \$ 0.62 |
| Shares used in computing net income per share: | | |
| Basic | 38,582 | 37,289 |
| Diluted | 39,847 | 38,398 |

See accompanying notes to condensed consolidated financial statements.

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

| | Three Months Ended March 31, | |
|---|---|------------------|
| | 2008 | 2007 |
| Operating Activities: | | |
| Net income | \$ 44,781 | \$ 23,802 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 3,139 | 2,423 |
| Amortization of intangible assets | 1,489 | 429 |
| Deferred income taxes | (2,619) | (721) |
| Income tax benefits from employee stock option plans and acquisition | 20,056 | 14,154 |
| Excess tax benefit from stock-based compensation | (19,241) | (12,467) |
| Share-based compensation expense | 14,564 | 8,105 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (5,314) | 4,200 |
| Inventory | (6,437) | (1,931) |
| Prepays and other assets | (915) | (1,045) |
| Accounts payable | (5,805) | 3,172 |
| Accrued compensation and employee benefits | (11,843) | (7,131) |
| Deferred revenue | 5,440 | 2,588 |
| Other accrued liabilities | 2,089 | (2,209) |
| Net cash provided by operating activities | 39,384 | 33,369 |
| Investing Activities: | | |
| Purchase of investments | (150,448) | (114,932) |
| Proceeds from sales and maturities of investments | 191,139 | 80,506 |
| Acquisition of property and equipment | (6,949) | (2,705) |
| Net cash provided by (used in) investing activities | 33,742 | (37,131) |
| Financing Activities: | | |
| Proceeds from issuance of common stock, net | 15,019 | 9,660 |
| Excess tax benefit from stock-based compensation | 19,241 | 12,467 |
| Net cash provided by financing activities | 34,260 | 22,127 |
| Effect of exchange rate changes on cash and cash equivalents | 597 | |
| Net increase in cash and cash equivalents | 107,983 | 18,365 |
| Cash and cash equivalents, beginning of period | 122,825 | 34,390 |
| Cash and cash equivalents, end of period | \$ 230,808 | \$ 52,755 |

See accompanying notes to condensed consolidated financial statements.

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.

NOTE 1. DESCRIPTION OF BUSINESS

Intuitive Surgical, Inc. designs, manufactures, and markets the *da Vinci* Surgical System, which is an advanced surgical system that the Company believes represents a new generation of surgery. The *da Vinci* Surgical System consists of a surgeon's console, a patient-side cart, a high performance vision system and proprietary wristed instruments. The *da Vinci* Surgical System seamlessly translates the surgeon's natural hand movements on instrument controls at the console into corresponding micro-movements of instruments positioned inside the patient through small puncture incisions, or ports. The Company markets its products through sales representatives in the United States, and through a combination of sales representatives and distributors in its international markets.

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 (collectively, the Company) have been prepared on a consistent basis with the December 31, 2007 audited consolidated financial statements and include all adjustments, consisting of only normal recurring adjustments, necessary to fairly state the information set forth herein. These financial statements have been prepared in accordance with the regulations of the Securities and Exchange Commission (SEC), and, therefore, omit certain information and footnote disclosure necessary to present the statements in accordance with accounting principles generally accepted in the United States of America. 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, 2007, which was filed on February 14, 2008. The results of operations for the first quarter of fiscal 2008 may not be indicative of the results to be expected for the entire fiscal year or any future periods.

Recent Accounting Pronouncements

Effective January 1, 2008, the Company adopted EITF 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities (EITF 07-3). EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. The adoption did not have a material impact on the Company's consolidated results or operations or financial condition.

Effective January 1, 2008, the Company adopted SFAS No. 157, Fair Value Measurements (SFAS 157). In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157, which provides a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. Therefore, the Company has adopted the provisions of SFAS 157 with respect to its financial assets and liabilities only. SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined under SFAS 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

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

Table of Contents

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

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

The adoption of this statement did not have a material impact on the Company's consolidated results of operations and financial condition.

Effective January 1, 2008, the Company adopted SFAS No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). SFAS 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for specified financial assets and liabilities on a contract-by-contract basis. The Company did not elect to adopt the fair value option under this Statement.

NOTE 3. FAIR VALUE

In accordance with SFAS 157, the following table represents the Company's fair value hierarchy for its financial assets (cash equivalents and investments) measured at fair value on a recurring basis as of March 31, 2008 (in thousands):

| | Level 1 | Level 2 | Level 3 | Total |
|--------------------------|------------|------------|-----------|------------|
| Money Market funds | \$ 101,311 | | | \$ 101,311 |
| Commercial paper | | \$ 78,559 | | 78,559 |
| Municipal bonds | | | \$ 90,723 | 90,723 |
| U.S. corporate debt | | 214,442 | | 214,442 |
| U.S. government agencies | | 101,104 | | 101,104 |
| Total | \$ 101,311 | \$ 394,105 | \$ 90,723 | \$ 586,139 |

Level 3 assets consist of municipal bonds with an auction reset feature (auction rate securities) whose underlying assets are generally student loans which are substantially backed by the federal government. In February 2008, auctions began to fail for these securities and each auction since then has failed. Based on the overall failure rate of these auctions, the frequency of the failures, and the underlying maturities of the securities, a portion of which are greater than 30 years, we have classified auction rate securities as long-term assets on our balance sheet. These investments were valued at fair value as of March 31, 2008. The following table provides a summary of changes in fair value of the Company's Level 3 financial assets as of March 31, 2008 (in thousands):

| | Municipal Bonds |
|--|-----------------|
| Balance at December 31, 2007 | \$ 158,262 |
| Unrealized loss included in other comprehensive income | (4,427) |
| Net settlements | (63,112) |
| Balance at March 31, 2008 | \$ 90,723 |

Table of Contents**NOTE 4. AVAILABLE-FOR-SALE SECURITIES**

The following table summarizes the Company's investments, which are all classified as available-for-sale (in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2008 | | | | |
| Short-term investments: | | | | |
| Commercial paper | \$ 70,540 | \$ 69 | \$ (35) | \$ 70,574 |
| U.S. corporate debt | 81,027 | 315 | (26) | 81,316 |
| U.S. government agencies | 4,265 | 7 | (2) | 4,270 |
| Total short-term investments | \$ 155,832 | \$ 391 | \$ (63) | \$ 156,160 |
| Long-term investments: | | | | |
| Municipal bonds | \$ 95,150 | \$ | \$ (4,427) | \$ 90,723 |
| U.S. corporate debt | 131,808 | 1,739 | (421) | 133,126 |
| U.S. government agencies | 88,138 | 699 | | 88,837 |
| Total long-term investments | \$ 315,096 | \$ 2,438 | \$ (4,848) | \$ 312,686 |
| Total short and long-term investments | \$ 470,928 | \$ 2,829 | \$ (4,911) | \$ 468,846 |
| December 31, 2007 | | | | |
| Short-term investments: | | | | |
| Commercial paper | \$ 43,953 | \$ 35 | \$ (1) | \$ 43,987 |
| Municipal bonds | 156,250 | | | 156,250 |
| U.S. corporate debt | 88,499 | 15 | (106) | 88,408 |
| U.S. government agencies | 15,997 | 3 | (3) | 15,997 |
| Total short-term investments | \$ 304,699 | \$ 53 | \$ (110) | \$ 304,642 |
| Long-term investments: | | | | |
| Municipal bonds | \$ 2,000 | \$ 12 | \$ | \$ 2,012 |
| U.S. corporate debt | 154,573 | 914 | (319) | 155,168 |
| U.S. government agencies | 50,593 | 141 | | 50,734 |
| Total long-term investments | \$ 207,166 | \$ 1,067 | \$ (319) | \$ 207,914 |
| Total short and long-term investments | \$ 511,865 | \$ 1,120 | \$ (429) | \$ 512,556 |

Table of Contents

The following is a summary of the amortized cost and estimated fair value of investments at March 31, 2008 by maturity date (in thousands):

| | Amortized Cost | Fair Value |
|--------------------------------|-------------------|---------------|
| Mature in less than one year | \$ 155,832 | \$ 156,160 |
| Mature in one to five years | 219,946 | 221,963 |
| Mature in more than five years | 95,150 | 90,723 |
| Total | \$ 470,928 | \$ 468,846 |

As of March 31, 2008 and December 31, 2007, unrealized loss on available-for-sale securities, net of tax, of \$1.3 million and unrealized gain on available-for-sale securities, net of tax, of \$0.4 million, respectively, were included in accumulated other comprehensive income in the accompanying unaudited Condensed Consolidated Balance Sheets.

NOTE 5. BALANCE SHEET DETAILS

The following table provides details of selected balance sheet items (in thousands):

| | March 31, 2008 | December 31, 2007 |
|-----------------|-------------------|----------------------|
| Inventory: | | |
| Raw materials | \$ 14,411 | \$ 12,809 |
| Work-in-process | 2,556 | 3,257 |
| Finished goods | 21,865 | 16,350 |
| Total | \$ 38,832 | \$ 32,416 |

Table of Contents**NOTE 6. STOCKHOLDERS EQUITY*****Comprehensive Income***

The components of comprehensive income are as follows (in thousands):

| | Three Months Ended March 31, | |
|---|---------------------------------|------------------|
| | 2008 | 2007 |
| Net income, as reported | \$ 44,781 | \$ 23,802 |
| Other comprehensive income: | | |
| Foreign currency translation adjustments | 379 | (18) |
| Change in unrealized gain / (loss) on available-for-sale securities, net of tax | (1,663) | 808 |
| Comprehensive income | \$ 43,497 | \$ 24,592 |

The components of accumulated other comprehensive income are as follows (in thousands):

| | March 31, 2008 | December 31, 2007 |
|---|-------------------|----------------------|
| Accumulated net unrealized gain / (loss) on available-for-sale securities, net of tax | \$ (1,251) | \$ 412 |
| Foreign currency translation adjustments | 497 | 118 |
| Total accumulated other comprehensive income/(loss) | \$ (754) | \$ 530 |

Stock Option Plans

The Company has several stock-based compensation plans (the Plans) that are described in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007. The Company, under the various equity plans, grants stock options for shares of common stock to employees and directors. In accordance with the Plans, the stated exercise price for non-qualified stock options shall not be less than 85 percent of the estimated fair market value of common stock on the date of grant. Incentive stock options may not be granted at less than 100 percent of the estimated fair market value of the common stock. The Plans provide that the options shall be exercisable over a period not to exceed ten years. The majority of options granted under the Plans vest over a period of four years. Certain options granted under the Plans vest over shorter periods.

Table of Contents

A summary of stock option activity under the Plans for the three months ended March 31, 2008 is presented as follows:

| | Shares Available for Grant | Stock Options Outstanding Number Outstanding | Weighted Average Exercise Price Per Share |
|---|----------------------------------|--|---|
| Balance at December 31, 2007 (with 1,446,466 options exercisable at a weighted-average exercise price of \$50.29 per share) | 7,595,732 | 3,136,231 | \$ 88.20 |
| Options granted | (1,022,500) | 1,022,500 | 299.91 |
| Options exercised | | (185,074) | 56.68 |
| Options forfeited/expired | 36,809 | (36,809) | 228.96 |
| Balance at March 31, 2008 (with 1,469,001 options exercisable at a weighted-average exercise price of \$54.21 per share) | 6,610,041 | 3,936,848 | \$ 143.37 |

Employee Stock Purchase Plan (ESPP)

Under the Employee Stock Purchase Plan, employees purchased approximately 46,700 shares for \$4.5 million and 68,200 shares for \$3.3 million during the three months ended March 31, 2008 and March 31, 2007, respectively.

Stock-based Compensation

The following table summarizes stock-based compensation charges:

| | Three Months Ended March 31, | |
|--|------------------------------|----------|
| | 2008 | 2007 |
| Cost of sales - products | \$ 1,266 | \$ 724 |
| Cost of sales - services | 982 | 477 |
| Total cost of sales | 2,248 | 1,201 |
| Selling, general and administrative | 9,017 | 5,214 |
| Research and development | 3,299 | 1,690 |
| Stock-based compensation expense before income tax benefit | 14,564 | 8,105 |
| Income taxes | 5,177 | 2,767 |
| Stock-based compensation expense after income taxes | \$ 9,387 | \$ 5,338 |

Table of Contents

The fair value of each option grant and the fair value of the option component of the Employee Stock Purchase Plan 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:

| | STOCK OPTIONS | | ESPP | |
|--|--------------------|----------|--------------------|----------|
| | Three Months Ended | | Three Months Ended | |
| | March 31, | | March 31, | |
| | 2008 | 2007 | 2008 | 2007 |
| Average risk free interest rate | 2.77% | 4.68% | 2.19% | 5.06% |
| Average expected term (years) | 5.0 | 5.2 | 1.3 | 1.3 |
| Average expected volatility | 52% | 38% | 57% | 40% |
| Weighted average fair value at grant date | \$ 143.09 | \$ 46.79 | \$ 101.03 | \$ 33.34 |
| Total stock-based compensation expense (000 s) | \$ 13,533 | \$ 7,386 | \$ 1,031 | \$ 719 |

NOTE 7. INCOME TAXES

As part of the process of preparing the unaudited Condensed Consolidated Financial Statements, the Company is required to estimate its income taxes in each of the jurisdictions in which it operates. This process involves estimating the current tax liability under the most recent tax laws and assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in the unaudited Condensed Consolidated Balance Sheets.

Income tax expense for the quarter ended March 31, 2008 was \$28.6 million, or 39.0% of pre-tax income, compared to \$15.1 million, or 38.9% of pre-tax income for the three months ended March 31, 2007. The effective tax rate for the first quarter of 2008 differs from the U.S. federal statutory rate of 35% primarily due to state income taxes, partially offset by domestic production deductions. The effective tax rate for the first quarter of 2007 differs from the U.S. federal statutory rate of 35% primarily due to state income taxes, partially offset by research and development credits.

Effective January 1, 2007, the Company adopted Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (FAS 109). As a result of the implementation of FIN 48, the Company recognized a \$2.0 million increase in a liability for unrecognized tax benefits, which was accounted for as a reduction to the January 1, 2007 balance of retained earnings. The Company classifies interest and penalties as a component of tax expense.

As of March 31, 2008, the Company has total gross unrecognized tax benefits of approximately \$26.8 million compared with approximately \$22.0 million as of December 31, 2007, representing an increase of approximately \$4.8 million for the first three months of fiscal 2008. Of the total gross unrecognized tax benefits, \$21.5 million, if recognized, would reduce our effective tax rate in the period of recognition. Interest and penalties are immaterial and are included in the unrecognized tax benefits.

The Company files federal, state and foreign income tax returns in many jurisdictions in the United States and abroad. For U.S. federal and California income tax purposes, the statute of limitation currently remains open for all years since inception due to utilization of net operating losses and research and development credits generated in prior years.

Table of Contents**NOTE 8. NET INCOME PER SHARE**

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

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2008 | 2007 |
| Net income | \$ 44,781 | \$ 23,802 |
| Basic: | | |
| Weighted-average shares outstanding | 38,582 | 37,289 |
| Basic net income per share | \$ 1.16 | \$ 0.64 |
| Diluted: | | |
| Weighted-average shares outstanding used in basic calculation | 38,582 | 37,289 |
| Add common stock equivalents | 1,265 | 1,109 |
| Weighted-average shares used in computing diluted net income per share | 39,847 | 38,398 |
| Diluted net income per share | \$ 1.12 | \$ 0.62 |

Employee stock options to purchase approximately 688,176 and 1,868,106 shares for the three months ended March 31, 2008 and 2007, respectively, were outstanding, but were not included in the computation of diluted earnings per share because the effect would have been antidilutive.

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, and our refer to Intuitive Surgical, Inc.

This management's discussion and analysis of financial condition as of March 31, 2008 and results of operations for the three months ended March 31, 2008 and 2007 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, 2007.

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements relate to expectations concerning matters that are not historical facts. Words such as projects, believes, anticipates, plans, expects, intends and similar 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, 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. Readers are cautioned that these forward-looking statements 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, 2007 and other periodic filings with the Securities and Exchange Commission, particularly in Part I, Item 1A: Risk Factors. Our actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

Intuitive®, Intuitive Surgical®, *da Vinci*®, *da Vinci*®S, *da Vinci S HD Surgical System*, *da Vinci Sonicpro*, *EndoWrist*®, *InSite*®, *3DHD*, *Cardiovac*, *Clearfield*®, *Alpha*®, *AESOP*®, *HERMES*®, and *ZEUS*®, are trademarks of Intuitive Surgical, Inc.

Overview

Products. We design, manufacture and market *da Vinci* Surgical Systems, which are advanced surgical systems that we believe represent a new generation of surgery. The *da Vinci* Surgical System consists of a surgeon's console, a patient-side cart and a high performance vision system. The product line also includes proprietary wristed instruments and surgical accessories. The *da Vinci* Surgical System seamlessly translates the surgeon's natural hand movements on instrument controls at a console into corresponding micro-movements of instruments positioned inside the patient through small puncture incisions, or ports. We believe that the *da Vinci* Surgical System is the only commercially available technology that can provide the surgeon with intuitive control, range of motion, fine tissue manipulation capability and 3-D HD visualization, while simultaneously allowing the surgeons to work through the small ports of minimally invasive surgery, or MIS. By placing computer-enhanced technology between the surgeon and the patient, we believe that the *da Vinci* Surgical System enables surgeons to improve clinical outcomes while reducing the invasiveness of complex surgical procedures. The *da Vinci* Surgical System is sold into multiple surgical specialties, principally urology, gynecology, cardiothoracic, and general surgery.

Business Model. In our business model, we generate revenue from both the initial capital sales of *da Vinci* Surgical Systems as well as recurring revenue, comprised of instrument, accessory, service and training revenue. The *da Vinci* Surgical System generally sells for approximately \$1.0 million to \$1.7 million, depending on configuration, and represents a significant capital equipment investment for our customers. We then generate recurring revenue as our customers purchase our *EndoWrist* instruments and accessory products for use in performing procedures with the *da Vinci* Surgical System. *EndoWrist* instruments and accessories will either expire or wear out as they are used in surgery and will need to be replaced as they are consumed. We generate additional recurring revenue from ongoing system service. We typically enter into service contracts at the time the system is sold. These service contracts have been generally renewable at the end of the service period, typically at an annual rate of approximately \$100,000 to \$150,000 per year, depending on configuration of the underlying system.

Since the introduction of the *da Vinci* Surgical System in 1999, our established base of *da Vinci* Surgical Systems has grown and robotic surgery volume has increased. Recurring revenue has grown at an equal or faster rate than system revenue. Over the past five years, revenue generated from the sale of instruments and accessories, service and training increased from 33% of revenue in 2003 to 46% of revenue in 2007. Recurring revenue for the three months ended March 31, 2008 was \$89.1 million, or 47% of total revenue. We expect recurring revenue to become a larger percentage of total revenue in the future.

Table of Contents

Regulatory Activities

We believe that we have obtained all of the clearances required to market our products to our targeted surgical specialties within the United States. As we make additions to target procedures, we will continue to obtain the necessary clearances. The following table lists chronologically our FDA clearances to date:

July 2000 General laparoscopic procedures

March 2001 Non-cardiac thoracoscopic procedures

May 2001 Prostatectomy procedures

November 2002 Cardiotomy procedures

July 2004 Cardiac revascularization procedures

March 2005 Urologic surgical procedures

April 2005 Gynecologic surgical procedures

June 2005 Pediatric surgical procedures

On March 19, 2008, we received clearance to market our system-held cardiac stabilizer and permission to remove the warning in our labeling regarding system use in non-arrested heart procedures.

2008 Business Events and Trends

Introduction. We experienced rapid growth during 2007 and through the first quarter of 2008, which was driven by the continued adoption of the *da Vinci* Surgical System for use in urologic, gynecologic, cardiothoracic, and general surgeries.

First Quarter 2008 Financial Highlights

Revenue grew 65% to \$188.2 million from \$114.2 million during the first quarter of 2007.

Recurring revenue grew 53% to \$89.1 million from \$58.1 million during the first quarter of 2007.

Instruments and accessories revenue grew 54% to \$61.9 million from \$40.3 million during the first quarter of 2007.

System revenue grew 76% to \$99.1 million from \$56.1 million during the first quarter of 2007.

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

We sold 74 *da Vinci* Surgical Systems during the first quarter of 2008, an increase of 68% compared to 44 in the first quarter of 2007.

As of March 31, 2008, we had a *da Vinci* Surgical System installed base of 867 systems, 647 in United States, 148 in Europe, and 72 in the rest of the world.

Operating income increased by 89% to \$64.9 million, or 34% of revenue, during the first quarter of 2008 from \$34.3 million, or 30% of revenue during the first quarter of 2007. Operating income included \$14.6 million and \$8.1 million during the first quarter of 2008 and 2007, respectively, of stock-based compensation expense for the estimated value of employee stock options and stock purchases.

Our business continues to demonstrate the ability to generate significant positive cash flow while supporting our rapid business growth. Cash, cash equivalents, and investments increased by \$64.3 million from the fourth quarter of 2007, as we ended the first quarter of 2008 with \$699.7 million in cash, cash equivalents, and investments.

Table of Contents

Procedure adoption

We believe the adoption of *da Vinci* surgery occurs surgical procedure by surgical procedure, and it is being adopted for those procedures which offer significant patient value. The value of a surgical procedure to a patient is higher if it offers superior clinical outcomes, less surgical trauma, or both.

The procedures that have driven the most growth in our business recently are the *da Vinci* Prostatectomy (dVP) and the *da Vinci* Hysterectomy (dVH). dVP procedures are expected to grow approximately 40% from 2007 to 2008 and dVH procedures are expected to grow approximately 150% from 2007 to 2008.

Table of Contents**RESULTS OF OPERATIONS**

The following table sets forth, for the periods indicated, certain unaudited Condensed Consolidated Statements of income information (in thousands):

| | March 31, 2008 | Three months Ended % of total revenue | March 31, 2007 | % of total revenue |
|---|-------------------|---|-------------------|-----------------------|
| Revenue: | | | | |
| Products | \$ 160,951 | 86% | \$ 96,449 | 84% |
| Services | 27,243 | 14% | 17,780 | 16% |
| Total revenue | 188,194 | 100% | 114,229 | 100% |
| Cost of revenue: | | | | |
| Products | 44,852 | 24% | 29,106 | 25% |
| Services | 13,535 | 7% | 8,615 | 8% |
| Total cost of revenue | 58,387 | 31% | 37,721 | 33% |
| Products gross profit | 116,099 | 62% | 67,343 | 59% |
| Services gross profit | 13,708 | 7% | 9,165 | 8% |
| Gross profit | 129,807 | 69% | 76,508 | 67% |
| Operating costs and expenses: | | | | |
| Selling, general, and administrative | 48,634 | 26% | 33,945 | 30% |
| Research and development | 16,301 | 9% | 8,224 | 7% |
| Total operating costs and expenses | 64,935 | 35% | 42,169 | 37% |
| Income from operations | 64,872 | 34% | 34,339 | 30% |
| Interest and other income, net | 8,541 | 5% | 4,608 | 4% |
| Income before taxes | 73,413 | 39% | 38,947 | 34% |
| Income tax expense | 28,632 | 15% | 15,145 | 13% |
| Net income | \$ 44,781 | 24% | \$ 23,802 | 21% |

Total Revenue

Total revenue increased to \$188.2 million for the three months ended March 31, 2008 from \$114.2 million for the three months ended March 31, 2007. First quarter of 2008 revenue growth was driven by the continued adoption of *da Vinci* surgery. We believe that robotic surgery will be adopted surgical procedure by surgical procedure. Our revenue growth during the periods presented reflects adoption in all of our target procedures. *da Vinci* prostatectomy (dVP) has been our most successful procedure to date and has been a significant sales catalyst. An increasing body of clinical evidence has indicated that dVP offers superior surgical outcomes compared to traditional open prostatectomy in the critical categories of cancer removal, continence, and sexual potency. In 2006 and through the first quarter of 2008, *da Vinci* Hysterectomy (dVH) has been one of our fastest growing procedures. Favorable clinical results have been reported in hysterectomies for cancerous pathology, which include increased lymph node retrieval counts and significant reduction in blood transfusion. For most patients who otherwise would have open surgery, a minimally invasive approach using the *da Vinci* Surgical System offers reduced pain, less blood loss, shorter hospital stays and a quicker return to normal daily activities .

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

Revenue within the United States accounted for 77% of total revenue for the three months ended March 31, 2008 and 82% of revenue for the three months ended March 31, 2007. We believe domestic revenue accounts for the large majority of total revenue primarily due to the competitive nature of the domestic healthcare market. As adoption progresses and as we reach standard of care for target procedures, we expect international revenue to continue to increase as a percentage of overall revenue.

Table of Contents

The following table summarizes our revenue for the three months ended March 31, 2008 and 2007 (in millions, except percentages):

| | Three Months Ended March 31, | |
|-----------------------------|---------------------------------|----------|
| | 2008 | 2007 |
| Revenue | | |
| Instruments and accessories | \$ 61.9 | \$ 40.3 |
| Systems | 99.1 | 56.1 |
| Total product revenue | 161.0 | 96.4 |
| Services and training | 27.2 | 17.8 |
| Total revenue | \$ 188.2 | \$ 114.2 |
| Recurring revenue | \$ 89.1 | \$ 58.1 |
| % of total revenue | 47% | 51% |
| Domestic | \$ 144.0 | \$ 93.2 |
| International | 44.2 | 21.0 |
| Total revenue | \$ 188.2 | \$ 114.2 |
| % of domestic revenue | 77% | 82% |
| % of international revenue | 23% | 18% |

Product Revenue

Product revenue increased to \$161.0 million for the three months ended March 31, 2008 from \$96.4 million for the three months ended March 31, 2007. The \$64.5 million (67%) increase was due to higher revenue from sales of instruments and accessories, and systems.

Instruments and accessories revenue increased to \$61.9 million for the three months ended March 31, 2008, up 54% compared with \$40.3 million for the three months ended March 31, 2007. The increase is driven by a similar increase in procedures. Procedure growth occurred in all our targeted procedures with prostatectomy and hysterectomy being the largest drivers of growth. Utilization per installed system for the three months ended March 31, 2008 also increased as compared to the three months ended March 31, 2007.

Systems revenue increased to \$99.1 million during the three months ended March 31, 2008 from \$56.1 million during the three months ended March 31, 2007, primarily due to the growth in the number of system unit sales, reflecting adoption of robotic surgery, increased average selling price (ASPs) resulting from the higher priced *da Vinci S* and *da Vinci S HD* Surgical Systems, and favorable foreign exchange impact of Euro-denominated sales. We sold 74 *da Vinci* Surgical Systems during the three months ended March 31, 2008, compared to 44 systems sold during the three months ended March 31, 2007.

The following table summarizes *da Vinci* Surgical System unit sales for the three months ended March 31, 2008 and 2007:

Table of Contents

| | Three Months Ended March 31, | |
|--------------------------|---------------------------------|-----------|
| | 2008 | 2007 |
| <i>da Vinci S 3-D HD</i> | 60 | 21 |
| <i>da Vinci S 4-arm</i> | 10 | 17 |
| <i>da Vinci S 3-arm</i> | 3 | |
| standard <i>da Vinci</i> | 1 | 6 |
| Total | 74 | 44 |

We also recognized revenue from HD and fourth arm upgrades of \$1.6 million during the three months ended March 31, 2008 compared to \$1.1 million during the three months ended March 31, 2007. The average revenue recognized per *da Vinci* system sold increased to \$1.32 million during the three months ended March 31, 2008, compared to \$1.25 million during the three months ended March 31, 2007 primarily due to the sales mix of *da Vinci S* and *da Vinci S HD* Systems which have a higher selling price than standard *da Vinci* Systems .

Service Revenue

Service revenue, comprised primarily of system service, increased to \$27.2 million for the three months ended March 31, 2008 from \$17.8 million for the three months ended March 31, 2007. We typically enter into service contracts at the time systems are sold. These service contracts have been generally renewed at the end of the service period. Higher service revenue for first quarter of 2008 was driven by a larger base of *da Vinci* Surgical Systems producing contract service revenue and higher revenue earned per system under service contract. There were approximately 795 systems under service contract entering the first quarter of 2008 generating an average of \$34,000 per system for the quarter, compared to 559 systems entering the first quarter of 2007 generating an average of \$32,000 per system. The increase in service revenue per system was driven by a higher percentage of the installed base being comprised of *da Vinci S* and *da Vinci S HD* Surgical Systems, which carry a higher contractual service rate than standard model *da Vinci* Systems.

Gross Profit

Product gross profit during the three months ended March 31, 2008 was \$116.1 million, or 72% of product revenue, compared to \$67.3 million, or 70% of product revenue, during the three months ended March 31, 2007. The higher first quarter of 2008 product gross profit was driven by higher 2008 product revenue, as described above. The higher 2008 product gross profit percentage was driven by the higher 2008 *da Vinci* Surgical Systems average selling prices, higher margins earned on Euro-based sales, and instrument and system material cost reductions. Product gross profit for the three months ended March 31, 2008 and 2007 included \$1.3 and \$0.7 million of stock-based compensation expense, respectively.

Service gross profit during the three months ended March 31, 2008 was \$13.7 million, or 50% of service revenue, compared to \$9.2 million, or 52% during the three months ended March 31, 2007. The higher first quarter of 2008 service gross profit is a result of the higher service revenue for the period. The decline in service gross margin percentage was primarily due to higher 2008 service inventory repair costs and stock-based compensation expenses. Service gross profit for the three months ended March 31, 2008 and 2007 included \$1.0 and \$0.5 million of stock-based compensation expenses, respectively.

Selling, General and Administrative Expenses

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

Selling, general and administrative expenses for the three months ended March 31, 2008 were \$48.6 million, up 43% from \$33.9 million for the three months ended March 31, 2007. The increase is due to organizational growth to support our expanding business, higher commissions and other variable compensation related to higher revenue levels, and increased stock-based compensation. Selling, general and administrative expenses are expected to increase in the future to support our expanding business. Stock-based compensation expense charged to sales, general and administrative expenses for the three months ended March 31, 2008 and 2007 were \$9.0 million and \$5.2 million, respectively.

Research and Development Expenses

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

Table of Contents

Research and development expenses for the three months ended March 31, 2008 were \$16.3 million, compared to \$8.2 million for the three months ended March 31, 2007. The increase is due to the growth in our research and development organization, costs associated with co-development arrangements with third parties, higher prototype expenses, and stock-based compensation expenses. Stock-based compensation expenses charged to research and development expenses for the three months ended March 31, 2008 and 2007 were \$3.3 million and \$1.7 million, respectively. We expect to continue to make substantial investments in research and development and anticipate that research and development expenses, including the aforementioned co-development arrangements with third parties, will continue to increase in the future.

Interest and Other Income, Net

Interest and other income, net, comprised mostly of interest income, was \$8.5 million for the three months ended March 31, 2008, compared to \$4.6 million for the three months ended March 31, 2007. The increase resulted from \$2.8 million of higher interest income earned on higher cash and investment balances and \$1.1 million of foreign exchange gains.

Income Tax Expense

Income tax expense for the three months ended March 31, 2008 was \$28.6 million, or 39.0% of pre-tax income, compared to \$15.1 million, or 38.9% of pre-tax income for the three months ended March 31, 2007. The effective tax rate for the first quarter of 2008 differs from the U.S. federal statutory rate of 35% primarily due to state income taxes, partially offset by domestic production deductions. The effective tax rate for the first quarter of 2007 differs from the U.S. federal statutory rate of 35% primarily due to state income taxes, partially offset by research and development credits. We have net operating loss carry forwards and employee stock tax benefits that will be utilized in fiscal 2008. Approximately \$41.3 million of employee stock tax benefits have been generated in the three months ended March 31, 2008. As a result, we estimate that our cash outlay for income taxes in fiscal year 2008 will be less than 25% of pre-tax income.

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

Our principal source of liquidity is cash provided by operations and the exercise of stock options. Cash and cash equivalents plus short and long-term investments increased from \$635.4 million at December 31, 2007 to \$699.7 million at March 31, 2008. Cash generation is one of our fundamental strengths and provides us with substantial financial flexibility in meeting our operating, investing and financing needs.

Consolidated Cash Flow Data

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2008 | 2007 |
| | (in thousands) | |
| Net cash provided by (used in) | | |
| Operating activities | \$ 39,384 | \$ 33,369 |
| Investing activities | 33,742 | (37,131) |
| Financing activities | 34,260 | 22,127 |
| Effect of exchange rates on cash and cash equivalents | 597 | |
| Net increase in cash and cash equivalents | \$ 107,983 | \$ 18,365 |

Table of Contents

Operating Activities

For the three months ended March 31, 2008, cash flow from operations of \$39.4 million was 88% of our net income of \$44.8 million for the following reasons:

1. Our net income included substantial non-cash charges in the form of stock-based compensation, taxes, and depreciation and amortization of long-lived assets. These non-cash charges totaled \$17.4 million.

2. We invested \$22.8 million in working capital for the three months ended March 31, 2008.

Working capital is comprised primarily of accounts receivable, inventory, deferred revenue and other current liabilities. Accounts receivable increased \$5.3 million or 4% in the first quarter of 2008, reflecting the timing of system sales. Inventory increased \$6.4 million or 20% in the first quarter of 2008 reflecting growth in our business. Deferred revenue, which includes deferred service contract revenue that is being amortized over the service contract period, increased \$5.4 million or 10% in the first quarter of 2008, which is primarily related to the increase in the number of installed systems for which service contracts exist. Other liabilities including accounts payable, accrued compensation and employee benefits, and accrued liabilities decreased \$15.6 million or 16% in the first quarter of 2008 primarily due to the payment of 2007 incentive compensation and the purchase of stock by employees under the Employee Stock Purchase Plan (ESPP) during the three months ended March 31, 2008.

For the three months ended March 31, 2007, cash flow from operations of \$33.4 million exceeded our net income of \$23.8 for the following reasons:

1. Our net income included substantial non-cash charges in the form of stock-based compensation, taxes, depreciation and amortization of long-lived assets of approximately \$11.9 million.

2. We invested \$2.3 million in working capital for the three months ended March 31, 2007.

Investing Activities

Net cash provided by investing activities during the three months ended March 31, 2008 consisted primarily of sales and maturities of investments (net of proceeds from purchases of investments) of \$40.7 million, partially offset by purchases of property and equipment of \$6.9 million. Net cash used in investing activities during the three months ended March 31, 2007 consisted primarily of purchases of investments (net of proceeds from sales and maturities of investments) of \$34.4 million and purchases of property and equipment and licensing of patents of \$2.7 million. Our investments are in U.S. government notes and bonds, corporate notes and bonds, commercial paper and auction rate securities. We generated approximately 4.4% interest in the first quarter of 2008. We are not a capital-intensive business. Our purchases of property and equipment during the three months ended March 31, 2008 related mainly to facilities improvements and information technology infrastructure to support capacity expansion in our business.

Financing Activities

Net cash provided by financing activities during the three months ended March 31, 2008 consisted primarily of proceeds from stock option exercises of \$15.0 million and excess tax benefits from stock-based compensation of \$19.2 million. Net cash flows provided by financing activities in the first quarter of 2007 consisted primarily of proceeds from stock option and warrants exercises of \$9.7 million and excess tax benefits from stock-based compensation of \$12.5 million.

Auction Rate Securities

As of March 31, 2008, we held approximately \$91 million of municipal bonds with an auction reset feature (auction rate securities) whose underlying assets are generally student loans which are substantially backed by the federal government. In February 2008, auctions began to fail for these securities and each auction since then has failed. Based on the overall failure rate of these auctions, the frequency of the failures, and the underlying maturities of the securities, a portion of which are greater than 30 years, we have classified these investments as long-term assets

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

on our balance sheet. These investments were valued at fair value as of March 31, 2008.

All of our auction rate securities are currently rated AAA, the highest rating, by a rating agency. If the issuers are unable to successfully close future auctions or refinance their debt in the near term and their credit ratings deteriorate, we may in the future be required to record an additional impairment charge on these investments. Based on our expected operating cash flows and our other sources of cash, we do not anticipate the current lack of liquidity on these investments will affect our ability to execute our current business plan.

Table of Contents

CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates are discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007 and we have added the following two policies discussed below.

Effective January 1, 2008, we adopted SFAS No. 157, Fair Value Measurements (SFAS 157). In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157, which provides a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. Therefore, we have adopted the provisions of FAS 157 with respect to its financial assets and liabilities only. SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined under SFAS 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

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

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

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

The adoption of this statement did not have a material impact on our consolidated results of operations and financial condition.

Effective January 1, 2008, we adopted SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. We did not elect to adopt the fair value option for certain financial instruments on the adoption date.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
Interest Rate and Market Risk

The primary objective of our investment activities is to preserve principal while at the same time maximizing the income we receive from our investments without significantly increasing risk. To achieve this objective, we maintain our portfolio of cash equivalents and short-term and long-term investments in a variety of securities, including U.S. government agencies, municipal bonds which may have an auction reset feature, corporate notes and bonds, commercial paper, and money market funds. The securities, other than money market funds, are classified as available for sale and consequently are recorded on the balance sheet at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive income (loss). All investments mature within approximately 3 years from the date of purchase excluding auction rate securities. Our holdings of the securities of any one issuer, except government agencies, do not exceed 5% of the portfolio. If interest rates rise, the market value of our investments may decline, which could result in a realized loss if we are forced to sell an investment before its scheduled maturity. A hypothetical increase in interest rate by 25 basis points would have resulted in a decrease in the fair value of our net investment position of approximately \$1.1 million as of March 31, 2008. We do not utilize derivative financial instruments to

Edgar Filing: INTUITIVE SURGICAL INC - Form 10-Q

manage our interest rate risks.

As of March 31, 2008, we held approximately \$91 million of municipal bonds, classified as long-term assets, with an auction reset feature (auction rate securities) whose underlying assets are generally student loans which are substantially backed by the federal government. In February 2008, auctions began to fail for these securities and each auction since then has failed. Effective January 1, 2008, we determine the fair market values of our financial instruments based on the fair value hierarchy established in

Table of Contents

SFAS 157 which requires an entity to maximize the use of observable inputs (Level 1 and Level 2 inputs) and minimize the use of unobservable inputs (Level 3 inputs) when measuring fair value. Given the current failures in the auction markets to provide quoted market prices of the securities as well as the lack of any correlation of these instruments to other observable market data, we valued these securities using a discounted cash flow methodology with the most significant input categorized as Level 3. Significant inputs that went into the model were the credit quality of the issuer, the percentage and the types of guarantees (such as Federal Family Education Loan Program FFELP), the probability of the auction succeeding or the security being called, and an illiquidity discount factor. Changes in the assumptions of our model based on dynamic market conditions could have a significant impact on the valuation of these securities, which may lead us in the future to take an impairment charge for these securities.

Foreign Exchange Risk

The majority of our revenue, expense, and capital purchasing activities are transacted in U.S. dollars. However, since a portion of our operations consists of sales activities outside of the United States, we have entered into transactions in other currencies, primarily the Euro, and therefore are subject to foreign exchange risk. Our foreign operations also incur most of their expenses in the local currency.

For the three months ended March 31, 2008, sales denominated in foreign currencies were approximately 11%, of total revenue. For the three months ended March 31, 2008, our revenue would have decreased by approximately \$2.1 million, if the US dollar exchange rate used would have strengthened by 10%. In addition, we have assets and liabilities denominated in foreign currencies. A 10% strengthening of the US dollar exchange rate at March 31, 2008, would have resulted in a \$3.6 million decrease in the carrying amounts of those net assets.

Our international operations are subject to risks typical of international operations, including, but not limited to, differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions, and foreign exchange rate volatility. We do not utilize derivative financial instruments to manage our exchange rate risks.

ITEM 4. CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

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

As required by SEC Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of March 31, 2008.

Changes in Internal Control Over Financial Reporting

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

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are involved in various ordinary and routine legal proceedings and disputes that arise in the normal course of business. These matters include product liability actions, patent infringement actions, contract disputes, and other matters. We do not know whether we will prevail in these matters nor can we assure that any remedy could be reached on commercially viable terms, if at all. Based on currently available information, we believe that we have meritorious defenses to these actions and that the resolution of these cases is not likely to have a material adverse effect on our business, financial position or future results of operations. In accordance with Statement of Financial Accounting Standards, or SFAS, No. 5,

Accounting for Contingencies, we record a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case.

ITEM 1A. RISK FACTORS

There have been no material changes in the Company's risk factors from those disclosed in the 2007 Annual Report on Form 10-K.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Table of Contents

| Exhibit Number | Description |
|---------------------------|--|
| 31.1 | Certification of the Company's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Company's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of the Company's Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of the Company's Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

Table of Contents

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

INTUITIVE SURGICAL, INC.

(Registrant)

By: /s/ MARSHALL L. MOHR

Marshall L. Mohr

Senior Vice President and Chief Financial Officer

Date: April 18, 2008

Table of Contents

EXHIBIT INDEX

| Exhibit Number | Description |
|---------------------------|--|
| 31.1 | Certification of the Company's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Company's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of the Company's Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of the Company's Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |