

VARIAN MEDICAL SYSTEMS INC

Form 10-Q

May 08, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2006

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 1-7598

VARIAN MEDICAL SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

94-2359345

(I.R.S. Employer
Identification Number)

**3100 Hansen Way,
Palo Alto, California**

(Address of principal executive offices)

94304-1030

(Zip Code)

(650) 493-4000

(Registrant's telephone number, including area code)

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 131,387,751 shares of Common Stock, par value \$1 per share, outstanding as of April 28, 2006.

VARIAN MEDICAL SYSTEMS, INC.

FORM 10-Q for the Quarter Ended March 31, 2006

INDEX

		Page No.
<u>Part I.</u>	<u>Financial Information</u>	<u>3</u>
<u>Item 1.</u>	<u>Financial Statements</u>	
	<u>Condensed Consolidated Statements of Earnings</u>	<u>3</u>
	<u>Condensed Consolidated Balance Sheets</u>	<u>4</u>
	<u>Condensed Consolidated Statements of Cash Flows</u>	<u>5</u>
	<u>Notes to the Condensed Consolidated Financial Statements</u>	<u>6</u>
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>21</u>
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>37</u>
<u>Item 4.</u>	<u>Controls and Procedures</u>	<u>38</u>
<u>Part II.</u>	<u>Other Information</u>	<u>39</u>
<u>Item 1.</u>	<u>Legal Proceedings</u>	<u>39</u>
<u>Item 1A.</u>	<u>Risk Factors</u>	<u>39</u>
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>54</u>
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>	<u>54</u>
<u>Item 4.</u>	<u>Submission of Matters to a Vote of Security Holders</u>	<u>54</u>
<u>Item 5.</u>	<u>Other Information</u>	<u>55</u>
<u>Item 6.</u>	<u>Exhibits</u>	<u>56</u>
<u>Signatures</u>		<u>57</u>
<u>Index to Exhibits</u>		<u>58</u>

PART I**FINANCIAL INFORMATION****Item 1. Financial Statements****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS****(Unaudited)**

(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	March 31, 2006	April 1, 2005	March 31, 2006	April 1, 2005
Revenues:				
Product	\$ 351,721	\$ 296,950	\$ 626,694	\$ 545,121
Service contracts and other	62,137	53,929	121,395	104,714
Total revenues	413,858	350,879	748,089	649,835
Cost of revenues:				
Product	206,337	168,528	368,082	314,114
Service contracts and other	36,436	32,196	70,158	60,382
Total cost of revenues	242,773	200,724	438,240	374,496
Gross margin	171,085	150,155	309,849	275,339
Operating expenses:				
Research and development	25,012	20,228	47,229	38,596
Selling, general and administrative	66,549	50,667	123,332	96,857
Total operating expenses	91,561	70,895	170,561	135,453
Operating earnings	79,524	79,260	139,288	139,886
Interest income	3,633	1,987	6,383	3,945
Interest expense	(1,099)	(1,335)	(2,183)	(2,840)
Earnings from operations before taxes	82,058	79,912	143,488	140,991
Taxes on earnings	26,260	25,760	46,530	46,530
Net earnings (1)	\$ 55,798	\$ 54,152	\$ 96,958	\$ 94,461
Net earnings per share - Basic	\$ 0.42	\$ 0.41	\$ 0.74	\$ 0.71
Net earnings per share - Diluted	\$ 0.41	\$ 0.39	\$ 0.71	\$ 0.68
Weighted average shares used in the calculation of:				
Net earnings per share - Basic	131,926	133,082	131,492	133,532
Net earnings per share - Diluted	136,821	138,427	136,368	139,223

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(1) For the three months and six months ended March 31, 2006, net earnings included total share-based compensation expense, net of taxes under SFAS 123(R), of \$7,501 and \$12,966, respectively. For the three months and six months ended April 1, 2005, net earnings included share-based compensation expense, net of taxes, related to restricted stock, of \$155 and \$423, respectively. See Note 11 of the Notes to the Condensed Consolidated Financial Statements for additional information.

See accompanying notes to the consolidated financial statements.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except par values)		March 31, 2006	September 30, 2005 (1)
Assets			
Current assets:			
Cash and cash equivalents	\$	266,265	\$ 243,086
Short-term marketable securities		127,290	135,356
Accounts receivable, net		371,301	351,899
Inventories		177,365	164,873
Prepaid expenses and other		27,472	26,211
Deferred tax assets		101,329	95,470
Total current assets		1,071,022	1,016,895
Property, plant and equipment, net		119,811	114,540
Long-term marketable securities			3,679
Goodwill		121,389	121,389
Other assets		67,752	60,899
Total assets	\$	1,379,974	\$ 1,317,402
Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable	\$	70,643	\$ 71,007
Accrued expenses		282,826	315,287
Current maturities of long-term debt		2,697	2,689
Product warranty		39,421	39,407
Advance payments from customers		128,277	115,543
Total current liabilities		523,864	543,933
Long-term accrued expenses and other		55,837	57,124
Long-term debt		57,210	57,318
Total liabilities		636,911	658,375
Commitments and contingencies (Note 8)			
Stockholders' equity:			
Preferred stock of \$1 par value: 1,000 shares authorized; none issued and outstanding			
Common stock of \$1 par value: 189,000 shares authorized; 131,805 and 130,715 shares issued and outstanding at March 31, 2006 and at September 30, 2005, respectively		131,805	130,715
Capital in excess of par value		239,225	152,263
Deferred stock compensation			(1,797)
Retained earnings		377,854	383,667
Accumulated other comprehensive loss		(5,821)	(5,821)
Total stockholders' equity		743,063	659,027
Total liabilities and stockholders' equity	\$	1,379,974	\$ 1,317,402

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(1) The condensed consolidated balance sheet as of September 30, 2005 was derived from audited financial statements as of that date, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

See accompanying notes to the consolidated financial statements.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)	Six Months Ended	
	March 31, 2006	April 1, 2005
Cash flows from operating activities:		
Net earnings	\$ 96,958	\$ 94,461
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Tax benefits from exercises of share-based payment awards	46,061	13,080
Excess tax benefits from share-based compensation	(43,455)	
Share-based compensation expense	19,876	631
Depreciation	11,773	10,528
Provision for doubtful accounts receivable	233	736
Amortization of intangibles	2,928	2,728
Amortization of premium/discount on marketable securities, net	80	279
Deferred taxes	(6,064)	(30)
Net change in fair value of derivatives and underlying commitments	3,877	(2,388)
Gain on equity investment in affiliate	(1,357)	(1,054)
Loss/(gain) on disposal of property, plant and equipment	(13)	121
Other	72	405
Changes in assets and liabilities:		
Accounts receivable	(25,254)	(17,986)
Inventories	(10,705)	(34,820)
Prepaid expenses and other current assets	(7,165)	(1,907)
Accounts payable	(114)	8,491
Accrued expenses	(29,689)	15,950
Product warranty	74	(1,877)
Advance payments from customers	13,008	23,310
Long-term accrued expenses and other liabilities	(579)	(522)
Net cash provided by operating activities	70,545	110,136
Cash flows from investing activities:		
Proceeds from maturities of marketable securities	46,665	203,160
Purchases of marketable securities	(35,000)	(87,800)
Acquisition of businesses, net of cash acquired		(12,147)
Purchases of property, plant and equipment	(17,371)	(14,321)
Proceeds from disposal of property, plant and equipment	340	53
Equity investment in affiliate	(2,980)	
Increase in cash surrender value of life insurance	(3,541)	(5,238)
Note receivable from affiliate and other	(151)	(1,812)
Other, net	(90)	(391)
Net cash provided by (used in) investing activities	(12,128)	81,504
Cash flows from financing activities:		
Repurchases of common stock	(123,836)	(116,903)
Proceeds from issuance of common stock to employees	52,639	22,262
Excess tax benefits from share-based compensation	43,455	
Employees' taxes withheld for restricted performance shares issued	(8,077)	
Repayments of bank borrowings	(100)	(40)
Net cash used in financing activities	(35,919)	(94,681)
Effects of exchange rate changes on cash and cash equivalents	681	(2,187)

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Net increase in cash and cash equivalents	23,179	94,772
Cash and cash equivalents at beginning of period	243,086	132,870
Cash and cash equivalents at end of period	\$ 266,265	\$ 227,642

See accompanying notes to the consolidated financial statements.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Varian Medical Systems, Inc. (VMS) and subsidiaries (collectively, the Company) designs, manufactures, sells and services advanced equipment and software products for treating cancer with radiation. The Company also designs, manufactures, sells and services high quality, cost-effective X-ray tubes for original equipment manufacturers; replacement X-ray tubes; flat panel digital image detectors for filmless X-rays (commonly referred to as flat panel detectors or digital image detectors) for medical, scientific and industrial applications; and linear accelerators for security and inspection purposes.

Fiscal Year

The Company's fiscal year is the 52- or 53-week period ending on the Friday nearest September 30. Fiscal year 2006 is the 52-week period ending September 29, 2006, and fiscal year 2005 was the 52-week period ended September 30, 2005. The fiscal quarters ended March 31, 2006 and April 1, 2005 were both 13-week periods.

Basis of Presentation

The condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements and the accompanying notes are unaudited and should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended September 30, 2005. In the opinion of management, the condensed consolidated financial statements herein include adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Company's financial position as of March 31, 2006 and September 30, 2005, results of operations for the three and six months ended March 31, 2006 and April 1, 2005, and cash flows for the six months ended March 31, 2006 and April 1, 2005. The results of operations for the three and six months ended March 31, 2006 are not necessarily indicative of the operating results to be expected for the full fiscal year or any future periods.

Use of Estimates

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The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Share-Based Compensation Expense

Effective October 1, 2005, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including stock options, employee stock purchases related to the Varian Medical Systems, Inc. Employee Stock Purchase Plan (the Employee Stock Purchase Plan), deferred stock units and restricted stock based on their fair values. SFAS 123(R) supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), which the Company previously followed in accounting for stock-based awards. In March 2005, the SEC issued *Staff Accounting Bulletin No. 107* (SAB 107) to provide guidance on SFAS 123(R). The Company has applied SAB 107 in its adoption of SFAS 123(R). See Note 11 of the Notes to the Condensed Consolidated Financial Statements for a detailed discussion of SFAS 123(R).

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 123(R)-3 *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards* (FSP 123(R)-3). The Company has elected to adopt the short-cut method provided in FSP 123(R)-3 for calculating the tax effects of share-based compensation pursuant to SFAS 123(R). The short-cut method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of share-based compensation, and to

determine the subsequent impact on the APIC pool and the Condensed Consolidated Statements of Cash Flows of the tax effects of share-based compensation awards that are outstanding upon adoption of SFAS 123(R).

Recent Accounting Pronouncements

In December 2004, the FASB issued FSP No. 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004* (FSP 109-2), which provides guidance under SFAS No. 109, *Accounting for Income Taxes* (SFAS 109), with respect to recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (the Jobs Creation Act) on enterprises' income tax expense and deferred tax liability. The Jobs Creation Act was enacted on October 22, 2004. FSP 109-2 states that an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Jobs Creation Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS 109. The Company has not yet completed its evaluation of the impact of the repatriation provisions but currently expects to be in a position to finalize its assessment by the third quarter of fiscal year 2006. Based on the Company's analysis to date, however, it is reasonably possible that it may repatriate up to \$175 million. Under the Jobs Creation Act, the Company may be subject to U.S. tax on repatriated amounts. However, because the Company had previously expected to repatriate a portion of these same earnings without the tax benefits of the Jobs Creation Act, it is possible that the Company could recognize a net benefit of up to \$10 million related to the repatriation.

2. MARKETABLE SECURITIES

The carrying amounts of marketable securities, which are all municipal bonds, are reflected as follows:

(In millions)	March 31, 2006	September 30, 2005
Short-term marketable securities	\$ 127.3	\$ 135.3
Long-term marketable securities		3.7
Total marketable securities	\$ 127.3	\$ 139.0

3. INVENTORIES

The components of inventories are as follows:

(In millions)	March 31, 2006	September 30, 2005
Raw materials and parts	\$ 102.3	\$ 96.4
Work-in-progress	16.7	16.3
Finished goods	58.4	52.2
Total inventories	\$ 177.4	\$ 164.9

4. GOODWILL AND INTANGIBLE ASSETS

Pursuant to SFAS No. 142, *Goodwill and Intangible Assets* (SFAS 142), the Company performs an annual impairment test for goodwill and intangible assts with indefinite useful lives. The impairment test for goodwill is a two-step process. Step one consists of a comparison of the fair value of a reporting unit with its carrying amount, including the goodwill allocated to each reporting unit. If the carrying amount is in excess of the fair value, step two requires the comparison of the implied fair value of the reporting unit with the carrying amount of the reporting unit s goodwill. Any excess of the carrying value of the reporting unit s goodwill over the implied fair value of the reporting unit s goodwill will be recorded as an impairment loss. The impairment test for intangible assets with indefinite useful lives consists of a comparison of fair value to carrying value, with any excess of carrying value over fair value being recorded as an impairment loss. Intangible assets with finite useful lives are amortized using the straight-line method over their useful lives, which range from approximately two to twenty years.

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The Company performed its annual SFAS 142 goodwill impairment assessment for its three reporting units in the fourth quarter of fiscal year 2005 and determined that there was no impairment. However, the Company could be required to record impairment charges in future periods if indicators of potential impairment exist.

The following table reflects the gross carrying amount and accumulated amortization of the Company's intangible assets included in Other assets on the Condensed Consolidated Balance Sheets:

(In millions)	March 31, 2006	September 30, 2005
Intangible Assets:		
Acquired existing technology	\$ 14.1	\$ 14.1
Patents, licenses and other	13.9	13.9
Customer contracts and supplier relationship	10.1	10.1
Accumulated amortization	(21.3)	(18.4)
Net carrying amount	\$ 16.8	\$ 19.7

Amortization expense for intangible assets required to be amortized under SFAS 142 was \$1.4 million for both the three months ended March 31, 2006 and April 1, 2005 and \$2.9 million and \$2.7 million for the six months ended March 31, 2006 and April 1, 2005, respectively. The Company estimates amortization expense on a straight-line basis for the remaining six months of fiscal year 2006, fiscal years 2007 through 2010, and thereafter, to be as follows (in millions): \$2.9, \$4.5, \$3.1, \$2.4, \$2.0 and \$1.9.

The following table reflects goodwill allocated to the Company's reportable segments:

(In millions)	March 31, 2006	September 30, 2005
Oncology Systems	\$ 120.9	\$ 120.9
X-ray Products	0.5	0.5
Total	\$ 121.4	\$ 121.4

5. RELATED PARTY TRANSACTIONS

In fiscal years 1999 and 2000, VMS invested a total of \$5 million in a three member consortium for a 20% ownership interest in dpiX Holding Company LLC (dpiX Holding), which in turn invested \$25 million for an 80.1% ownership interest in dpiX LLC (dpiX), a supplier of amorphous silicon based thin-film transistor arrays (flat panels) for the Company's X-ray Products' digital image detector products and for its Oncology System's PortalVision imaging systems. The Company purchased flat panels from dpiX totaling approximately \$2.8 million and \$2.1 million for the three months ended March 31, 2006 and April 1, 2005, respectively and \$7.3 million and \$4.1 million for the six months ended March 31, 2006 and April 1, 2005, respectively, which are included as a component of Inventories in the Condensed Consolidated Balance Sheets and Cost of revenues-Product in the Condensed Consolidated Statements of Earnings for such periods. VMS had the right to appoint one manager of the five person board of managers and the investment was accounted for under the equity method. In accordance with the dpiX Holding agreement, net losses were to be allocated to the other two members, in succession, until their capital accounts equaled zero, before being allocated to VMS. The dpiX Holding agreement also provided that net profits were to be allocated to the other two members, in succession, until their capital accounts equaled the net losses previously allocated, then to the three members in accordance with their ownership

interests.

In September 2004, VMS acquired another member's 20% ownership interest in dpiX Holding for \$1 million. As a result, VMS has the right to appoint two managers of the five person board of managers and its ownership interest in dpiX Holding increased to 40%, with the remaining 60% being held by the other original member. When VMS acquired this additional 20% ownership interest, the capital account of the selling member was nearly zero because it was the first in the consortium to be allocated losses. However, dpiX Holding has been profitable since VMS acquired the additional 20% ownership interest. As a result, VMS was the first to be allocated net profits to recover previously allocated losses and recorded in the three months ended March 31, 2006 and April 1, 2005 income on equity investment in dpiX Holding of \$0.6 million and \$0.5 million, respectively, and in the six months ended March 31, 2006 and April 1, 2005 of \$1.4 million and \$1.0 million,

respectively, which is included in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings.

In accordance with the dpiX agreement, the member that owns the other 19.9% ownership interest in dpiX had the right to sell back to dpiX on dpiX's last business day in December 2004, 2005 and 2006, cumulatively all of that member's ownership interest for \$5 million if dpiX had not become a publicly traded company as of the last business day in December 2004. In December 2004, that member exercised its right to sell back to dpiX its 19.9% ownership interest. On each of December 22, 2005 and December 24, 2004, dpiX repurchased from that member a 7.96% ownership interest for a payment of \$2 million (in aggregate, a 15.92% interest for \$4 million). The remaining 3.98% membership interest will be repurchased by dpiX in December 2006. In accordance with the dpiX agreement, the repurchased ownership interest was allocated to the two remaining members of dpiX Holding. As a result, VMS's indirect ownership interest in dpiX has increased to 38.4% as of March 31, 2006.

In December 2004, VMS agreed to loan \$2 million to dpiX in four separate installments, bearing interest at prime rate plus 1% per annum. The principal balance is due and payable to VMS in twelve equal quarterly installments beginning in October 2006; interest is payable in full according to the same quarterly schedule, but beginning in April 2005; and the entire principal balance, together with accrued and unpaid interest thereon and all other related amounts payable thereunder, is fully due and payable on July 10, 2009. As of March 31, 2006, the note receivable from dpiX totaled \$2 million which is primarily included in Other assets in the Condensed Consolidated Balance Sheet.

In March 2006, VMS and the other member of dpiX Holding agreed in principle to invest an aggregate of \$92 million in dpiX Holding for dpiX to acquire and construct a manufacturing facility in Colorado to increase its production capacity. The members' contributions for this facility are based on their percentage of ownership interest in dpiX Holding. As such, VMS expects to invest approximately \$37 million over the next 12 to 15 months. As of March 31, 2006, VMS has contributed approximately \$3 million to dpiX Holding related to this facility.

6. PRODUCT WARRANTY

The Company provides for estimated future costs of warranty obligations in accordance with FASB Interpretation No. 45, *Guarantors' Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, which requires an entity to disclose and recognize a liability for the fair value of the obligation it assumes upon issuance of a guarantee. The Company warrants most of its products for a specific period of time, usually one year, against material defects. For software products, the Company warrants against material defects for usually three months. The Company provides for the estimated future costs of warranty obligations in cost of revenues when the related revenues are recognized. The accrued warranty costs represent the best estimate at the time of sale of the total costs that the Company will incur to repair or replace product parts that fail while still under warranty. The amount of accrued estimated warranty costs obligation for established products is primarily based on historical experience as to product failures adjusted for current information on repair costs. For new products, estimates will include historical experience of similar products, as well as reasonable allowance for start-up expenses. On a quarterly basis, the Company reviews the accrued warranty costs and updates the historical warranty cost trends.

The following table reflects the change in the Company's accrued product warranty during the six months ended March 31, 2006 and April 1, 2005:

(In millions)	Six Months Ended	
	March 31, 2006	April 1, 2005
Accrued product warranty, at beginning of period	\$ 39.4	\$ 40.7

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Charged to cost of revenues		18.6		13.5
Actual product warranty expenditures		(18.6)		(15.3)
Accrued product warranty, at end of period	\$	39.4	\$	38.9

7. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company has significant transactions denominated in foreign currencies and addresses certain financial exposures through a controlled program of risk management that includes the use of derivative financial instruments. The Company sells products throughout the world, often in the currency of the customer's country, and typically hedges most of these firmly committed foreign currency sales orders. These firmly committed foreign currency sales orders are hedged using forward exchange contracts. The Company enters into foreign currency forward exchange contracts primarily to reduce the effects of fluctuating foreign currency exchange rates. The forward exchange contracts range from one to twelve months in original maturity. As of March 31, 2006, the Company did not have any forward exchange contracts with an original maturity greater than twelve months. As international deliveries may extend beyond twelve months, the Company may hedge beyond twelve months in the future. The Company does not hold derivative instruments for speculative or trading purposes.

The Company accounts for its hedges of foreign currency denominated sales orders (firm commitments) as fair value hedges as prescribed by SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 149, *Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities* (SFAS 133). For the three and six months ended March 31, 2006, there were no material gains or losses due to hedge ineffectiveness. At March 31, 2006, the Company had foreign exchange forward contracts for fair value hedges with notional values to sell and purchase \$269.0 million and \$15.3 million, respectively, in various foreign currencies. At March 31, 2006, all open forward exchange contracts were deemed effective.

The Company also hedges balance sheet exposures from its various foreign subsidiaries and business units. The Company enters into monthly foreign currency forward exchange contracts to minimize the short-term impact of foreign currency fluctuations on assets and liabilities denominated in currencies other than the U.S. dollar functional currency. These monthly hedges of foreign-currency-denominated assets and liabilities do not qualify for hedge accounting treatment under SFAS 133. For derivative instruments not designated as hedging instruments, changes in their fair values are recognized in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings. Changes in the values of these hedging instruments are offset by changes in the values of foreign currency denominated assets and liabilities. Variations from the forecasted foreign currency assets or liabilities, coupled with a significant currency movement, may result in a material gain or loss if the hedges are not effectively offsetting the change in value of the foreign currency asset or liability.

8. COMMITMENTS AND CONTINGENCIES

Commitments

Following a decision by Mitsubishi Electric Co. (MELCO) to exit the radiotherapy equipment and service business and its desire to do so in a nondisruptive manner with an established radiotherapy equipment service provider, the Company entered into two separate transactions with MELCO contemporaneously whereby (i) the Company purchased MELCO's radiotherapy equipment service business (the Service Business) to service MELCO's existing customers and (ii) the Company formed a three-year joint venture (JVA) in Japan with MELCO that was effective as of February 3, 2004.

On February 2, 2004, the Company's Japanese subsidiary (VMS KK) purchased the Service Business in Japan and certain other Asian and South American countries for 2.0 billion Japanese Yen, or US\$19.1 million, plus a contingent earn out payable to MELCO at the end of the JVA period. This earn out payment is equivalent to 100% of the net profits or losses of the Service Business for a three-year period. The Company accounted for the purchase of the Service Business as an acquisition and 100% of the profits and losses from VMS KK are reflected in the Company's consolidated results. The Company accounts for the earn out payment equivalent to 100% of the net profits or losses of the Service

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Business during the three-year period as an adjustment to the purchase price of the acquisition at the end of the JVA period. For the period from February 2, 2004 to March 31, 2006, net profits for the Service Business totaled approximately \$3.4 million. Assuming no future profits or losses, \$3.4 million would be payable to MELCO at the end of the three-year JVA period.

In addition to purchasing the Service Business, the Company entered into a distributor arrangement with MELCO to sell MELCO radiotherapy equipment products through VMS KK for two years. During that two-year period ended February 2, 2006, the Company did not sell any MELCO radiotherapy equipment products.

The JVA was accomplished through MELCO's purchase on February 3, 2004 of a 35% ownership interest in VMS KK for 1.4 billion Japanese Yen, or US\$13.5 million. During the three-year JVA period, MELCO is not entitled to any profits or losses generated by VMS KK. However, MELCO is entitled to elect one of the five members of VMS KK's board of directors. At the end of the three-year JVA period, MELCO is required to unconditionally sell and the Company is required to unconditionally repurchase MELCO's 35% ownership interest in VMS KK at the original sale price (1.4 billion Japanese Yen) and there are no settlement alternatives to such a repurchase obligation. The Company has accounted for MELCO's 35% ownership interest as a mandatorily redeemable financial instrument, which is included in Long-term accrued expenses and other in the Condensed Consolidated Balance Sheets.

Contingencies

The U.S. Environmental Protection Agency or third parties have named the Company as a potentially responsible party under the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended (CERCLA), at eight sites where the Company, as Varian Associates, Inc., is alleged to have shipped manufacturing waste for recycling or disposal. In addition, the Company is overseeing environmental cleanup projects and, as applicable, reimbursing third parties for cleanup activities under the direction of, or in consultation with, federal, state and/or local agencies at certain current VMS or former Varian Associates, Inc. facilities (including facilities disposed of in connection with the Company's sale of its electron devices business during 1995 and the sale of its thin film systems business during 1997). Under the terms of the agreement governing the distribution of the shares (the spin-offs) of Varian, Inc. (VI) and Varian Semiconductor Equipment Associates, Inc. (VSEA), by the Company in 1999, VI and VSEA are each obligated to indemnify the Company for one-third of these environmental cleanup costs (after adjusting for any insurance proceeds realized or tax benefits recognized by the Company). The Company spent \$0.2 million (net of amounts borne by VI and VSEA) during both the three months ended March 31, 2006 and April 1, 2005, on environmental investigation, cleanup and third-party claim costs. The Company spent \$0.6 million (net of amounts borne by VI and VSEA) during both the six months ended March 31, 2006 and April 1, 2005, on environmental investigation, cleanup and third-party claim costs.

For one of these sites and facilities, various uncertainties make it difficult to assess the likelihood and scope of further cleanup activities or to estimate the future costs of such activities. In addition, various uncertainties make it difficult to estimate the likelihood or cost of certain third-party claims, project management costs and legal costs. As of March 31, 2006, the Company nonetheless estimated that the Company's future exposure (net of VI's and VSEA's indemnification obligations) to complete the cleanup projects for these activities ranged in the aggregate from \$3.7 million to \$7.1 million. The time frame over which the Company expects to complete the cleanup projects varies, ranging up to approximately 30 years as of March 31, 2006. Management believes that no amount in the foregoing range of estimated future costs is more probable of being incurred than any other amount in such range and therefore accrued \$3.7 million as of March 31, 2006. The amount accrued has not been discounted to present value due to the uncertainties that make it difficult to develop a best estimate of future costs.

As to other sites and facilities, the Company has gained sufficient knowledge based upon formal agreements with other parties defining the Company's future liabilities or formal cleanup plans for these sites that have either been approved by or completed in accordance with the requirements of the state or federal environmental agency with jurisdiction over the site to better estimate the scope and costs of future cleanup activities. As of March 31, 2006, the Company estimated that the Company's future exposure (net of VI's and VSEA's indemnification obligations) to complete the cleanup projects, including reimbursements of third-party's claims, for these sites and facilities ranged in the aggregate from \$10.2 million to \$45.5 million. The time frame over which these cleanup projects are expected to be completed varies with each site and facility, ranging from approximately 10 years to approximately 30 years as of March 31, 2006. As to each of these sites and facilities, management determined that a particular amount within the range of estimated costs was a better estimate of the future environmental liability than any other amount within the range, and that the amount and timing of these future costs were reliably determinable. The best estimate within the range was \$18.6 million at March 31, 2006. The Company accordingly accrued \$12.4 million, which represents its best estimate of the future costs of \$18.6 million discounted at 4%, net of inflation. This accrual is in addition to the \$3.7 million described in the preceding paragraph.

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The foregoing amounts are only estimates of anticipated future environmental-related costs to cover the known cleanup projects, and the amounts actually spent may be greater or less than such estimates. The aggregate range of cost estimates reflects various uncertainties inherent in many environmental cleanup activities, the large number of sites and facilities involved and the amount of third-party claims. The Company believes that most of these cost ranges will narrow as cleanup activities progress. The Company believes that its reserves are adequate, but as the scope of its obligations becomes more

clearly defined, these reserves (and the associated indemnification obligations of VI and VSEA) may be modified and related charges/credits against earnings may be made.

Although any ultimate liability arising from environmental-related matters described herein could result in significant expenditures that, if aggregated and assumed to occur within a single fiscal year would be material to the Company's consolidated financial statements, the likelihood of such occurrence is considered remote. Based on information currently available to management and its best assessment of the ultimate amount and timing of environmental-related events (and assuming VI and VSEA satisfy their indemnification obligations), management believes that the costs of these environmental-related matters are not reasonably likely to have a material adverse effect on the consolidated financial statements of the Company in any fiscal year.

The Company evaluates its liability for environmental-related investigation and cleanup costs in light of the liability and financial strength of potentially responsible parties and insurance companies with respect to which the Company believes that it has rights to contribution, indemnity and/or reimbursement (in addition to the obligations of VI and VSEA). Claims for recovery of environmental investigation and cleanup costs already incurred, and to be incurred in the future, have been asserted against various insurance companies and other third parties. The Company receives certain cash payments in the form of settlements and judgments from defendants, its insurers and other third parties from time to time. The Company has also reached an agreement with another insurance company under which the insurance company has agreed to pay a portion of the Company's past and future environmental-related expenditures, and the Company therefore included a \$3.1 million receivable in Other assets at March 31, 2006. The Company believes that this receivable is recoverable because it is based on a binding, written settlement agreement with a solvent and financially viable insurance company and the insurance company has in the past paid the claims that the Company has made.

The Company is also involved in other legal proceedings arising in the ordinary course of its business. While there can be no assurances as to the ultimate outcome of any litigation involving the Company, management does not believe any pending legal proceeding will result in a judgment or settlement that would have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

9. RETIREMENT PLANS

The Company's net defined benefit and post-retirement benefit costs were composed of the following:

(In thousands)	Three Months Ended		Six Months Ended	
	March 31, 2006	April 1, 2005	March 31, 2006	April 1, 2005
Defined Benefit Plans				
Service cost	\$ 929	\$ 758	\$ 1,858	\$ 1,516
Interest cost	844	777	1,688	1,554
Expected return on plan assets	(841)	(732)	(1,682)	(1,464)
Amortization of transition amount	(2)	60	(4)	120
Amortization of prior service cost	32	33	64	66
Recognized actuarial loss	213	179	426	358
Net pension benefit cost	\$ 1,175	\$ 1,075	\$ 2,350	\$ 2,150
Post-Retirement Benefit Plans				
Service cost	\$	\$	\$	\$
Interest cost	71	92	142	184

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Expected return on plan assets

Expected return on plan assets							
Amortization of transition amount		123		123		246	246
Amortization of prior service cost		1				2	
Recognized actuarial gain		(1)		(3)		(2)	(6)
Net pension benefit cost	\$	194	\$	212	\$	388	\$ 424

The Company made contributions to the defined benefit plans of \$3.0 million during the six months ended March 31, 2006. The Company currently expects total contributions to the defined benefit plans for fiscal year 2006 will be approximately

\$3.7 million. The Company made contributions to the post-retirement benefit plans of \$0.3 million during the six months ended March 31, 2006. The Company currently expects total contributions to the post-retirement benefit plans for fiscal year 2006 will be approximately \$0.5 million.

10. STOCKHOLDERS' EQUITY

Stock Repurchase Program

On November 21, 2005, the Company announced that its Board of Directors had authorized the repurchase by the Company of up to 6,000,000 shares of its common stock through December 31, 2006 in addition to the 1,500,000 shares of common stock that had been available for repurchase under the previously approved program as of September 30, 2005. During the six months ended March 31, 2006, the Company paid \$123.8 million to repurchase 2,395,100 shares of its common stock, of which \$84.6 million was paid during the three months ended March 31, 2006 to repurchase 1,500,000 shares. All shares that have been repurchased have been retired. As of March 31, 2006, 4,500,000 shares of the Company's common stock remained available for repurchase under the new program.

Comprehensive Earnings

Comprehensive earnings for the three and six months ended March 31, 2006 and April 1, 2005 equaled the reported net earnings.

11. EMPLOYEE STOCK PLANS

During fiscal year 1991, VMS adopted the stockholder-approved Omnibus Stock Plan (the "Omnibus Plan") under which shares of common stock could be issued to officers, directors, key employees and consultants. The Omnibus Plan was amended and restated as of the spin-offs. The maximum number of shares that could have been issued was limited to twenty million shares. Stock options granted under the Omnibus Plan have an exercise price equal to the fair market value of the underlying stock on the grant date and expire no later than ten years from the grant date. Options granted under the Omnibus Plan before November 2000 were generally exercisable in cumulative installments of one-third each year, commencing one year following date of grant. Options granted after November 2000 were exercisable in the following manner: the first one-third one year from the date of grant, with the remainder vesting monthly during the following two-year period. No further awards may be made under the Omnibus Plan.

In November 2000, VMS adopted the 2000 Stock Option Plan (the "2000 Plan"), which was intended to supplement the Omnibus Plan. The maximum number of shares that could have been issued was limited to twelve million shares. The 2000 Plan is similar to the Omnibus Plan in all material respects, with the exception that shares available for awards under the 2000 Plan could not be issued to directors or officers of VMS. Stock options granted under the 2000 Plan are exercisable for the first one-third of the option shares one year from the date of grant, with the remainder vesting monthly during the following two-year period. Other terms of the 2000 Plan mirror the Omnibus Plan. No further awards may be made under the 2000 Plan.

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In February 2005, VMS' s stockholders approved the 2005 Omnibus Stock Plan (the "2005 Plan"), which provides for the grant of equity incentive awards, including stock options, restricted stock, stock appreciation rights, performance units, restricted stock units and performance shares of up to (a) four million shares, plus (b) the number of shares authorized for issuance, but never issued, under the Omnibus Plan and the 2000 Plan, plus (c) the number of shares subject to awards previously granted under the Omnibus Plan and 2000 Plan that terminate, expire, or lapse and (d) amounts granted in substitution of options in connection with certain transactions. For purposes of the total number of shares available for grant under the 2005 Plan, any shares that are subject to awards of stock options or stock appreciation rights shall be counted against the available-for-grant limit as one share for every one share issued, and any shares issued in connection with awards other than stock options and stock appreciation rights shall be counted against the available-for-grant limit as three shares for every one share issued. All awards may be subject to restrictions on transferability and continued employment as determined by the Compensation and Management Development Committee.

In November 2005, the Company' s Board of Directors approved changes in the employee service requirement for grants of non-qualified stock options made on or after November 17, 2005 under the 2005 Plan to employees who qualify for retirement at the time of termination from the Company. Under the new requirements, if an employee retires within one year

of the grant date, the number of shares subject to the stock option shall be reduced proportionally by the time during such one-year period that the employee ceased to be an active, full-time employee of the Company (based upon a 365 day year). The revised number of shares subject to the stock option would continue to vest in accordance with the original vesting schedule, and the remaining shares cancelled as of the date of retirement. Under the old requirements, if an employee retired within one year of the grant date, all shares subject to the option grant would continue to vest in accordance with the original vesting schedule.

In February 2006, VMS's stockholders approved the Amended and Restated 2005 Omnibus Stock Plan (the "Amended 2005 Plan"), which modified the 2005 Plan to permit the grant of deferred stock units to non-employee directors. All other aspects of the Amended 2005 Plan are the same as in the 2005 Plan. Each deferred stock unit is deemed to be the equivalent of one share of VMS's common stock. Deferred stock units will vest over a period of not less than one year from the date of grant, unless otherwise provided in the grant agreement as determined by VMS's Board of Directors, and vesting may be pro rata during the vesting period. Payment of deferred stock units generally will be made in shares of VMS's common stock.

Effective October 1, 2005, the Company adopted SFAS 123(R) using the modified prospective transition method, which requires the measurement and recognition of compensation expense for all share-based payment awards made to the Company's employees and directors including stock options and employee stock purchases related to the Employee Stock Purchase Plan, deferred stock units and restricted stock based on fair values. The Company's financial statements as of and for the three and six months ended March 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Share-based compensation expense recognized is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Share-based compensation expense recognized in the Company's Condensed Consolidated Statements of Earnings during the three and six months ended March 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of, September 30, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, or SFAS 123, and compensation expense for the share-based payment awards granted subsequent to September 30, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company elected to attribute the value of share-based compensation to expense using the straight-line method, which was previously used for its pro forma information required under SFAS 123. During the three and six months ended March 31, 2006, total share-based compensation expense, before taxes on earnings, was \$11.7 million and \$19.9 million, respectively. During the three and six months ended April 1, 2005, there was no share-based compensation expense related to stock options and employee stock purchases recognized under the intrinsic value method of APB 25. During the three and six months ended April 1, 2005, share-based compensation expense related to restricted stock, before taxes on earnings, was \$0.2 million and \$0.6 million, respectively, which was recorded under APB 25.

Upon adoption of SFAS 123(R), the Company elected to value its share-based payment awards granted beginning in fiscal year 2006 using the Black-Scholes option-pricing model (the "Black-Scholes model"), which was previously used for its pro forma information required under SFAS 123. The Black-Scholes model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. The Black-Scholes model requires the input of certain assumptions. VMS's options and the option component of the Employee Stock Purchase Plan shares have characteristics significantly different from those of traded options, and changes in the assumptions can materially affect the fair value estimates.

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The fair value of options granted and the option component of the Employee Stock Purchase Plan shares were estimated at the date of grant using the Black-Scholes model with the following weighted average assumptions:

	Three Months Ended		Six Months Ended	
	March 31, 2006	April 1, 2005	March 31, 2006	April 1, 2005
Employee Stock Option Plans				
Expected term (in years)	4.25	4.00	4.18	4.00
Risk-free interest rate	4.5%	3.8%	4.4%	3.5%
Expected volatility	29.2%	28.4%	29.3%	30.4%
Expected dividend				
Weighted average fair value at grant date	\$ 17.65	\$ 10.72	\$ 15.50	\$ 11.66
Employee Stock Purchase Plan				
Expected term (in years)	0.50	0.50	0.50	0.50
Risk-free interest rate	4.8%	3.3%	4.5%	3.0%
Expected volatility	27.8%	21.1%	26.5%	22.8%
Expected dividend				
Weighted average fair value at grant date	\$ 9.33	\$ 9.76	\$ 9.17	\$ 10.86

The expected term of stock options represents the weighted-average period the stock options are expected to remain outstanding. The expected term is based on the observed and expected time to post-vesting exercise and forfeitures of option by employees. Upon the adoption of SFAS 123(R), the Company determined the expected term of stock options based on the demographic grouping of employees and retirement eligibility. Prior to October 1, 2005, the Company determined the expected term of stock options based on the demographic grouping of employees. Upon the adoption of SFAS 123(R), the Company used a combination of historical and implied volatility (blended volatility) in deriving its expected volatility assumption as allowed under SFAS 123(R) and SAB 107. Implied volatility was derived based on six-month traded options on VMS's common stock. Prior to October 1, 2005, the Company used its historical stock price volatility in accordance with SFAS 123 for purposes of its pro forma information. The selection of the blended volatility approach was based upon the availability of traded options on VMS's stock and the Company's assessment that blended volatility is more representative of future stock price trends than just historical volatility alone. The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of VMS's stock options. The expected dividend assumption is based on the Company's history and expectation of dividend payouts.

As share-based compensation expense recognized in the Condensed Consolidated Statements of Earnings for the three and six months ended March 31, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. In the Company's pro forma information required under SFAS 123 for the periods prior to October 1, 2005, the Company accounted for forfeitures as they occurred.

The table below summarizes the effect of recording share-based compensation expense und