

INTUITIVE SURGICAL INC

Form 10-Q

October 18, 2013

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-30713

Intuitive Surgical, Inc.

(Exact name of Registrant as specified in its Charter)

Delaware

(State or Other Jurisdiction of

Incorporation or Organization)

1266 Kifer Road

Sunnyvale, California 94086

(Address of principal executive offices) (Zip Code)

(408) 523-2100

(Registrant's telephone number, including area code)

77-0416458

(I.R.S. Employer

Identification Number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES ☒ NO ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES ☒ NO ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller Reporting company ☐

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

The Registrant had 38,064,183 shares of Common Stock, \$0.001 par value per share, outstanding as of October 8, 2013.



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INTUITIVE SURGICAL, INC.

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## INTUITIVE SURGICAL, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(IN MILLIONS, EXCEPT PAR VALUES)

(UNAUDITED)

	September 30, 2013	December 31, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$586.8	\$553.7
Short-term investments	626.1	770.7
Accounts receivable, net	280.6	370.3
Inventories	200.1	121.5
Prepays and other current assets	30.0	67.3
Deferred tax assets	9.9	9.3
Total current assets	1,733.5	1,892.8
Property, plant and equipment, net	294.2	241.8
Long-term investments	1,319.4	1,596.1
Long-term deferred tax assets	121.6	87.0
Intangible and other assets, net	91.3	103.4
Goodwill	137.4	138.1
Total assets	\$3,697.4	\$4,059.2
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current Liabilities:		
Accounts payable	\$62.0	\$57.6
Accrued compensation and employee benefits	54.9	104.0
Deferred revenue	192.6	185.7
Other accrued liabilities	57.8	54.3
Total current liabilities	367.3	401.6
Other long-term liabilities	65.8	77.5
Total liabilities	433.1	479.1
Contingencies (Note 5)		
Stockholders' equity		
Preferred stock, 2.5 shares authorized, \$0.001 par value, issuable in series; no shares issued and outstanding as of September 30, 2013 and December 31, 2012, respectively	—	—
Common stock, 100.0 shares authorized, \$0.001 par value, 38.1 shares and 40.2 shares outstanding as of September 30, 2013 and December 31, 2012, respectively	—	—
Additional paid-in capital	2,450.7	2,240.1
Retained earnings	813.2	1,333.4
Accumulated other comprehensive income	0.4	6.6
Total stockholders' equity	3,264.3	3,580.1
Total liabilities and stockholders' equity	\$3,697.4	\$4,059.2
See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).		

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INTUITIVE SURGICAL, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)

(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenue:				
Product	\$397.6	\$450.0	\$1,395.0	\$1,317.5
Service	101.4	87.8	293.9	252.0
Total revenue	499.0	537.8	1,688.9	1,569.5
Cost of revenue:				
Product	112.0	119.3	399.2	353.9
Service	30.3	28.4	93.5	83.2
Total cost of revenue	142.3	147.7	492.7	437.1
Gross profit	356.7	390.1	1,196.2	1,132.4
Operating expenses:				
Selling, general and administrative	139.3	129.0	426.3	374.1
Research and development	43.2	49.7	126.0	128.3
Total operating expenses	182.5	178.7	552.3	502.4
Income from operations	174.2	211.4	643.9	630.0
Interest and other income, net	3.9	4.3	12.5	12.1
Income before taxes	178.1	215.7	656.4	642.1
Income tax expense	21.3	32.4	151.6	160.4
Net income	\$156.8	\$183.3	\$504.8	\$481.7
Net income per share:				
Basic	\$4.06	\$4.59	\$12.75	\$12.10
Diluted	\$3.99	\$4.46	\$12.46	\$11.72
Shares used in computing net income per share:				
Basic	38.6	39.9	39.6	39.8
Diluted	39.3	41.1	40.5	41.1
Total comprehensive income	\$159.3	\$185.5	\$498.5	\$486.6

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

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INTUITIVE SURGICAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN MILLIONS)

(UNAUDITED)

	Nine Months Ended September 30,	
	2013	2012
Operating activities:		
Net income	\$504.8	\$481.7
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	32.6	25.2
Amortization of intangible assets	16.6	17.2
Accretion of discounts and amortization of premiums on investments, net	28.6	23.8
Deferred income taxes	(33.8)	(19.3)
Income tax benefits from employee stock option plans	29.7	54.8
Excess tax benefit from stock-based compensation	(31.1)	(54.7)
Share-based compensation expense	127.3	115.0
Changes in operating assets and liabilities, net of effects of acquisition:		
Accounts receivable	89.7	(34.8)
Inventories	(87.9)	(21.0)
Prepays and other assets	9.7	(5.5)
Accounts payable	4.4	6.9
Accrued compensation and employee benefits	(49.1)	(8.1)
Other liabilities	9.4	6.2
Net cash provided by operating activities	650.9	587.4
Investing activities:		
Purchase of investments	(1,130.0)	(1,448.8)
Proceeds from sales of investments	878.1	262.8
Proceeds from maturities of investments	649.8	569.1
Purchase of property, plant and equipment, intellectual property and business	(75.7)	(43.5)
Acquisition of business, net of cash acquired	—	(27.6)
Acquisition-related restricted cash	—	(15.0)
Net cash provided by (used in) investing activities	322.2	(703.0)
Financing activities:		
Proceeds from issuance of common stock, net	137.9	176.5
Excess tax benefit from stock-based compensation	31.1	54.7
Repurchase and retirement of common stock	(1,109.2)	(185.1)
Net cash provided by (used in) financing activities	(940.2)	46.1
Effect of exchange rate changes on cash and cash equivalents	0.2	(0.1)
Net increase (decrease) in cash and cash equivalents	33.1	(69.6)
Cash and cash equivalents, beginning of period	553.7	465.8
Cash and cash equivalents, end of period	\$586.8	\$396.2
See accompanying Notes to Condensed Consolidated Financial Statements (Unaudited).		

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INTUITIVE SURGICAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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

NOTE 1. DESCRIPTION OF BUSINESS

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

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

In the opinion of management, the accompanying unaudited Condensed Consolidated Financial Statements (“financial statements”) of Intuitive Surgical, Inc. and its wholly-owned subsidiaries have been prepared on a consistent basis with the audited Consolidated Financial Statements for the fiscal year ended December 31, 2012 and include all adjustments, consisting of only normal recurring adjustments, necessary to fairly state the information set forth herein. The financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (“SEC”), and, therefore, omit certain information and footnote disclosure necessary to present the financial statements in accordance with United States (“U.S.”) generally accepted accounting principles (“U.S. GAAP”). These financial statements should be read in conjunction with the audited Consolidated Financial Statements and Notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2012, which was filed on February 4, 2013. The results of operations for the first nine months of fiscal 2013 are not necessarily indicative of the results to be expected for the entire fiscal year or any future periods.

New Accounting Standards Recently Adopted

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

In June 2013, the Financial Accounting Standards Board determined that an unrecognized tax benefit should be presented as a reduction of a deferred tax asset for a net operating loss (“NOL”) carryforward or other tax credit carryforward when settlement in this manner is available under applicable tax law. This guidance is effective for the Company’s interim and annual periods beginning January 1, 2014. The Company does not believe the adoption of this guidance will have a material impact on its consolidated financial statements.

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## NOTE 3. FINANCIAL INSTRUMENTS

## Cash, Cash Equivalents and Investments

The following tables summarize the amortized cost, gross unrealized gains, gross unrealized losses, and fair value of the Company's cash and available-for-sale securities by investment category that are recorded as cash and cash equivalents, or short-term or long-term investments as of September 30, 2013 and December 31, 2012 (in millions):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short- term Investments	Long- term Investments
September 30, 2013							
Cash	\$183.1	\$—	\$—	\$183.1	\$183.1	\$—	\$—
Level 1:							
Money market funds	368.5	—	—	368.5	368.5	—	—
U.S. Treasuries	84.0	—	(0.4 )	83.6	—	33.7	49.9
Subtotal	452.5	—	(0.4 )	452.1	368.5	33.7	49.9
Level 2:							
Commercial paper	121.9	—	—	121.9	33.2	88.7	—
Corporate securities	758.7	2.8	(1.7 )	759.8	—	235.8	524.0
U.S. government agencies	425.0	1.0	(0.8 )	425.2	2.0	103.3	319.9
Non-U.S. government securities	68.0	0.3	(0.2 )	68.1	—	41.4	26.7
Municipal securities	513.8	1.2	(0.3 )	514.7	—	123.2	391.5
Subtotal	1,887.4	5.3	(3.0 )	1,889.7	35.2	592.4	1,262.1
Level 3:							
Municipal securities	8.0	—	(0.6 )	7.4	—	—	7.4
Subtotal	8.0	—	(0.6 )	7.4	—	—	7.4
Total assets measured at fair value	\$2,531.0	\$5.3	\$(4.0 )	\$2,532.3	\$586.8	\$626.1	\$1,319.4
December 31, 2012							
Cash	\$89.7	\$—	\$—	\$89.7	\$89.7	\$—	\$—
Level 1:							
Money market funds	388.1	—	—	388.1	388.1	—	—
U.S. Treasuries & corporate equity securities	179.2	0.2	—	179.4	—	155.4	24.0
Subtotal	567.3	0.2	—	567.5	388.1	155.4	24.0
Level 2:							
Commercial paper	157.4	—	—	157.4	75.9	81.5	—
Corporate securities	952.1	5.8	(0.4 )	957.5	—	274.6	682.9
U.S. government agencies	636.9	2.6	—	639.5	—	133.6	505.9
Non-U.S. government securities	90.8	0.5	—	91.3	—	21.8	69.5
Municipal securities	409.3	1.1	(0.2 )	410.2	—	103.8	306.4
Subtotal	2,246.5	10.0	(0.6 )	2,255.9	75.9	615.3	1,564.7
Level 3:							
Municipal securities	8.0	—	(0.6 )	7.4	—	—	7.4
Subtotal	8.0	—	(0.6 )	7.4	—	—	7.4
Total assets measured at fair value	\$2,911.5	\$10.2	\$(1.2 )	\$2,920.5	\$553.7	\$770.7	\$1,596.1





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

	Amortized Cost	Fair Value
Mature in less than one year	\$1,028.6	\$1,029.8
Mature in one to five years	1,311.3	1,312.0
Mature in after five years	8.0	7.4
Total	\$2,347.9	\$2,349.2

During the three and nine months ended September 30, 2013, net realized gains recognized on the sale of investments were approximately \$0.6 million and \$0.7 million, respectively. Net realized losses recognized on the sale of investments during the three and nine months ended September 30, 2012 were approximately \$0.2 million and \$1.7 million, respectively. As of September 30, 2013 and December 31, 2012, net unrealized gains of \$1.7 million and \$6.2 million, respectively, were included in accumulated other comprehensive income in the accompanying unaudited Condensed Consolidated Balance Sheets.

There have been no transfers between Level 1 and Level 2 measurements during the nine months ended September 30, 2013, and there were no changes in the Company's valuation technique. Level 3 assets consist of municipal bonds with auction rate securities ("ARS") whose underlying assets are student loans which are generally backed by the federal government. Since the auctions for these securities have continued to fail since February 2008, these investments are not currently trading and therefore do not have a readily determinable fair value. The Company has valued its ARS using a discounted cash flow model utilizing unobservable inputs including estimates of interest rates, timing and amount of cash flows, credit and liquidity premiums and expected holding periods of the ARS.

#### Foreign currency derivatives

The objective of the Company's hedging program is to mitigate the impact of changes in currency exchange rates on net cash flow from foreign currency denominated sales and intercompany balances and other monetary assets or liabilities denominated in currencies other than the U.S. dollar. The Company has \$3.0 million of derivative liabilities recorded as other accrued liabilities in the unaudited Condensed Consolidated Balance Sheets at September 30, 2013, compared to \$2.7 million of derivative liabilities recorded as other accrued liabilities in the Condensed Consolidated Balance Sheets at December 31, 2012. The derivative liabilities are measured using Level 2 fair value inputs.

#### Cash Flow Hedges

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

As of September 30, 2013, the Company had notional amounts of EUR 36.9 million and KRW 1.8 billion of outstanding currency forward contracts entered into to hedge EUR and KRW denominated sales, compared to EUR 20.0 million and KRW 4.4 billion of outstanding currency forward contracts at December 31, 2012. The net gains (losses) reclassified to revenue related to the hedged revenue transactions for the three and nine months ended September 30, 2013 and 2012 were not significant. Other impacts of derivative instruments designated as cash flow hedges were not significant for the three and nine months ended September 30, 2013 and 2012.

#### Other Derivatives Not Designated as Hedging Instruments:

Other derivatives not designated as hedging instruments consist primarily of forward contracts that the Company uses to hedge intercompany balances and other monetary assets or liabilities denominated in currencies other than the U.S. dollar, primarily the EUR, the British Pound ("GBP"), the Swiss Franc ("CHF"), Japanese Yen ("JPY") and the KRW. Accordingly, any gains or losses from changes in the fair value of the forward contracts are recorded in interest and other income, net. The gains and losses on these forward contracts generally offset the gains and losses associated with the underlying assets and liabilities, which are also recorded in interest and other income, net. The duration of the forward contracts for hedging the Company's balance sheet exposure is approximately one month.



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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Recognized gains (losses) in interest and other income, net	\$(2.6	) \$—	\$(1.8	) \$0.6
Foreign exchange gains (losses) related to re-measurement	\$2.4	\$0.2	\$1.0	\$(0.4 )

The notional amounts for derivative instruments provide one measure of the transaction volume. Total gross notional amounts (in local currency) for derivatives (recorded at fair value) outstanding at the end of each period were as follows (in millions):

	September 30, 2013	December 31, 2012
European Euro	31.6	37.6
Korean Won	12,204.2	4,600.0
British Pound	7.0	5.4
Swiss Franc	—	1.0
Japanese Yen	70.0	—

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## NOTE 4. BALANCE SHEET DETAILS

## Inventories

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

	September 30, 2013	December 31, 2012
Inventories:		
Raw materials	\$59.1	\$41.2
Work-in-process	6.8	4.4
Finished goods	134.2	75.9
Total inventories	\$200.1	\$121.5

## NOTE 5. CONTINGENCIES

On August 6, 2010, a purported class action lawsuit entitled *Perlmutter v. Intuitive Surgical et al.*, No. CV10-3451, was filed against seven of the Company's current and former officers and directors in the United States District Court for the Northern District of California. The lawsuit seeks unspecified damages on behalf of a putative class of persons who purchased or otherwise acquired the Company's common stock between February 1, 2008 and January 7, 2009. The complaint alleges that the defendants violated federal securities laws by making allegedly false and misleading statements and omitting certain material facts in the Company's filings with the Securities and Exchange Commission. On February 15, 2011, the Police Retirement System of St. Louis was appointed lead plaintiff in the case pursuant to the Private Securities Litigation Reform Act of 1995. An amended complaint was filed on April 15, 2011, making allegations substantially similar to the allegations described above. On May 23, 2011, the Company filed a motion to dismiss the amended complaint. On August 10, 2011, that motion was granted and the action was dismissed; the plaintiffs were given 30 days to file an amended complaint. On September 12, 2011, plaintiffs filed their amended complaint. The allegations contained therein are substantially similar to the allegations in the prior complaint. The Company filed a motion to dismiss the amended complaint. A hearing occurred on February 16, 2012, and on May 22, 2012 the Company's motion was granted. The complaint was dismissed with prejudice, and a final judgment was entered in the Company's favor on June 1, 2012. On June 20, 2012, plaintiffs filed a notice of appeal with the United States Court of Appeals for the Ninth Circuit. The appeal is styled *Police Retirement System of St. Louis v. Intuitive Surgical, Inc. et al.*, No. 12-16430. Plaintiffs filed their opening brief on September 28, 2012. The Company filed an answering brief on November 13, 2012, and plaintiffs filed a reply brief on December 17, 2012. No oral argument date has been set, and the appeal remains pending.

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

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On April 26, 2013, a purported class action lawsuit entitled *Abrams v. Intuitive Surgical et al.*, No. 5-13-cv-1920, was filed against nine of the Company's current and former officers and directors in the United States District Court for the Northern District of California. A substantially identical complaint, entitled *Adel v. Intuitive Surgical, et al.*, No. 5:13-cv-02365, was filed in the same court against the same defendants on May 24, 2013. The Adel case was voluntarily dismissed without prejudice on August 20, 2013. The Abrams lawsuit seeks unspecified damages on behalf of a putative class of persons who purchased or otherwise acquired the Company's common stock between October 19, 2011 and April 18, 2013. The complaint alleges that the defendants violated federal securities laws by making allegedly false and misleading statements and omitting certain material facts in the Company's filings with the Securities and Exchange Commission. Motions seeking appointment as lead plaintiff in the Abrams case were filed by two parties on June 25, 2013. One of those motions was subsequently withdrawn. The remaining motion is scheduled to be heard on November 22, 2013. By agreement with the plaintiff in the Abrams action, no response to the complaint is required until after a lead plaintiff is appointed by the Court and that duly appointed lead plaintiff files a consolidated complaint or informs us that it has chosen to proceed with the complaint already on file. Also by agreement with plaintiff, the lead plaintiff filed a consolidated complaint on October 15, 2013, and the Company must respond by December 16, 2013.

The Company is currently named as a defendant in about 50 individual product liability lawsuits filed in various state and federal courts by plaintiffs who allege that they underwent surgical procedures that utilized the da Vinci Surgical System and sustained a variety of personal injuries and, in some cases, death as a result of such surgery. In addition, the Company has been named as a defendant in a purported class action filed in Louisiana state court seeking damages on behalf of all patients who were allegedly injured by the da Vinci Surgical System at a single hospital in Louisiana. The cases raise a variety of allegations including, to varying degrees, that the plaintiffs' injuries resulted from purported defects in the da Vinci Surgical System and/or failure on the Company's part to provide adequate training resources to the healthcare professionals who performed plaintiffs' surgeries. The cases further allege that the Company failed to adequately disclose and/or misrepresented the potential risks and/or benefits of the da Vinci Surgical System. Plaintiffs also assert a variety of causes of action, including for example, strict liability based on purported design defects, negligence, fraud, breach of express and implied warranties, unjust enrichment, and loss of consortium. Plaintiffs seek recovery for alleged personal injuries and, in many cases, punitive damages. Except for a few cases, including the Taylor case described below, these cases generally are in the early stages of pretrial activity. Plaintiffs' attorneys are engaged in well-funded national advertising campaigns soliciting clients who have undergone da Vinci surgery and claim to have suffered an injury. The plaintiffs' attorneys are now alleging that Intuitive Surgical is liable for those injuries under products liability theories. The Company has seen a substantial increase in these claims; however, the Company has not received detailed information regarding many of these claims. In an effort to provide an orderly process for evaluating claims before they result in costly litigation, the Company has entered into tolling agreements with certain plaintiffs' counsel acting on behalf of such claimants. The tolling agreements provide that the statute of limitations for each individual will be tolled for a period of three to six months in exchange for the individual's agreement that, if he or she ultimately files a lawsuit, it will be filed in certain agreed upon venues. The tolling agreements provide the parties and their legal counsel with additional time to evaluate the claims, and to explore whether the claims have merit and whether they can be resolved without litigation. The Company does not currently know how many individuals will ultimately file lawsuits or decide not to pursue their claims, nor is the Company able at this time to estimate the financial impact of their claims or predict the final disposition of such claims. Based on currently available information, the Company believes that it has meritorious defenses in the above matters and intends to assert them vigorously.

In February 2011, the Company was named as a defendant in a product liability action that had originally been filed in Washington State Superior Court for Kitsap County against the healthcare providers and hospital involved in the plaintiff's decedent's surgery (Josette Taylor, as Personal Representative of the Estate of Fred E. Taylor, deceased; and on behalf of the Estate of Fred E. Taylor v. Intuitive Surgical, Inc., No. 09-2-03136-5). In Taylor, plaintiff asserted wrongful death and product liability claims against the Company, generally alleging that the decedent died four years after surgery as a result of injuries purportedly suffered during the surgery, which was conducted with the use of the da Vinci Surgical System. The plaintiff in Taylor asserted that such injuries were caused, in whole or in part, by the

Company's purported failure to properly train, warn, and instruct the surgeon. The lawsuit sought unspecified damages for past medical expenses, pain and suffering, loss of consortium as well as punitive damages. A trial commenced in the action on April 15, 2013. On May 23, 2013, the jury returned a defense verdict, finding that the Company was not negligent. Judgment was entered in favor of Intuitive Surgical on June 7, 2013. Plaintiff has filed a notice of appeal. Due to the uncertainty surrounding the litigation process, the Company is unable, at this time, to reasonably predict the ultimate outcome of the above matters or estimate the possible loss or range of losses which may be incurred. Based on currently available information, the Company believes that it has meritorious defenses in the above matters and intends to assert them vigorously.

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

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Shares repurchased	1.8	0.3	2.6	0.4
Average price per share	\$398.87	\$495.09	\$429.09	\$497.28
Value of shares repurchased	\$693.8	\$169.8	\$1,109.2	\$185.1

On July 25, 2013 and March 20, 2013, the Company's Board of Directors (the "Board") authorized additional stock repurchases of \$779 million and \$1.0 billion, respectively. As of September 30, 2013, the remaining amount of share repurchases authorized by the Board was approximately \$1.0 billion.

On July 29, 2013, in connection with the stock repurchase authorization, the Company entered into an accelerated share repurchase program (the "ASR Program") with Goldman, Sachs & Co. ("Goldman") to repurchase \$500 million of the Company's common stock. Under the ASR Program, the Company paid an initial purchase price of \$500 million to Goldman and received an initial delivery of approximately 1.2 million shares of its common stock. On September 11, 2013, Goldman exercised its early termination option under the ASR Program and the pricing period was closed. The settlement price was \$385.16 per share. Based on this settlement price, the final number of shares repurchased by the Company and delivered by Goldman under the ASR Program was 1.3 million shares. The Company received the additional 0.1 million shares from Goldman on September 16, 2013 to settle the difference between the initial share delivery and the total number of shares repurchased.

In addition to the ASR Program, the Company repurchased an additional 0.5 million shares of the Company's common stock during the three months ended September 30, 2013. All of these shares were repurchased in the open market. All common stock repurchased has been retired as of September 30, 2013. As a result of the stock repurchases made during the three months ended September 30, 2013, the Company reduced common stock and APIC by an aggregate of \$57.4 million and charged \$636.4 million to retained earnings.



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## Accumulated Other Comprehensive Income

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

	Three Months Ended September 30, 2013			
	Gains (Losses) on Hedge Instruments	Unrealized Gains (Losses) on Available-for-Sale Securities	Foreign Currency Translation Gains (Losses)	Total
Beginning balance	\$0.6	\$ (2.8 )	\$0.1	\$ (2.1 )
Other comprehensive income before reclassifications	(3.0 )	3.9	0.5	1.4
Reclassified from accumulated other comprehensive income	0.5	0.6	—	1.1
Net current-period other comprehensive income	(2.5 )	4.5	0.5	2.5
Ending balance	\$ (1.9 )	\$ 1.7	\$0.6	\$0.4

	Three Months Ended September 30, 2012			
	Gains (Losses) on Hedge Instruments	Unrealized Gains (Losses) on Available-for-Sale Securities	Foreign Currency Translation Gains (Losses)	Total
Beginning balance	\$0.3	\$3.3	\$—	\$3.6
Other comprehensive income before reclassifications	(1.7 )	3.5	0.1	1.9
Reclassified from accumulated other comprehensive income	0.2	0.1	—	0.3
Net current-period other comprehensive income	(1.5 )	3.6	0.1	2.2
Ending balance	\$ (1.2 )	\$ 6.9	\$0.1	\$5.8

	Nine Months Ended September 30, 2013			
	Gains (Losses) on Hedge Instruments	Unrealized Gains (Losses) on Available-for-Sale Securities	Foreign Currency Translation Gains (Losses)	Total
Beginning balance	\$—	\$ 6.2	\$0.4	\$6.6
Other comprehensive income before reclassifications	(1.4 )	(5.4 )	0.2	(6.6 )
Reclassified from accumulated other comprehensive income	(0.5 )	0.9	—	0.4
Net current-period other comprehensive income	(1.9 )	(4.5 )	0.2	(6.2 )
Ending balance	\$ (1.9 )	\$ 1.7	\$0.6	\$0.4

	Nine Months Ended September 30, 2012			
	Gains (Losses) on Hedge Instruments	Unrealized Gains (Losses) on Available-for-Sale Securities	Foreign Currency Translation Gains (Losses)	Total

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Beginning balance	\$—	\$ 1.1	\$(0.2	) \$0.9
Other comprehensive income before reclassifications	(1.0	) 5.5	0.3	4.8
Reclassified from accumulated other comprehensive income	(0.2	) 0.3	—	0.1
Net current-period other comprehensive income	(1.2	) 5.8	0.3	4.9
Ending balance	\$(1.2	) \$ 6.9	\$0.1	\$5.8

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## NOTE 7. SHARE-BASED COMPENSATION

## Stock Option Plans

## 2009 Employment Commencement Incentive Plan

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

## 2010 Incentive Award Plan

On April 25, 2013, the Shareholders approved an amended and restated 2010 Incentive Award Plan (“2010 Plan”) to provide for an increase in the number of shares of common stock reserved for issuance from 3,650,000 to 4,850,000. A summary of stock option activity under all stock plans for the nine months ended September 30, 2013 is presented as follows (in millions, except per share amounts):

	Shares Available for Grant	Stock Options Outstanding Number Outstanding	Weighted Average Exercise Price Per Share
Balance at December 31, 2012	1.7	4.8	\$ 340.83
Options authorized	1.6	—	—
Options granted	(1.5	) 1.5	473.68
Options exercised	—	(0.4	) 253.53
Options forfeited/expired	0.1	(0.2	) 456.31
Balance at September 30, 2013	1.9	5.7	\$ 379.15

As of September 30, 2013, options to purchase an aggregate of 3.1 million shares of common stock were exercisable at a weighted-average price of \$312.11 per share.

## Employee Stock Purchase Plan

Under the Employee Stock Purchase Plan (“ESPP”), employees purchased approximately 37.7 thousand shares for \$12.4 million and 47.6 thousand shares for \$13.9 million during the three months ended September 30, 2013 and 2012, respectively. Employees purchased approximately 92.2 thousand shares for \$28.8 million and 96.8 thousand shares for \$27.8 million during the nine months ended September 30, 2013 and 2012, respectively.

## Share-based Compensation

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Cost of sales - products	\$5.2	\$4.3	\$13.2	\$10.6
Cost of sales - services	3.6	4.1	9.5	9.6
Total cost of sales	8.8	8.4	22.7	20.2
Selling, general and administrative	30.6	28.2	76.6	69.7
Research and development	11.0	10.7	28.0	25.1
Share-based compensation expense before income taxes	50.4	47.3	127.3	115.0
Income tax benefit	16.5	14.9	41.1	36.0
Share-based compensation expense after income taxes	\$33.9	\$32.4	\$86.2	\$79.0



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

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2013	2012	2013	2012	
<b>Stock Options</b>					
Average risk free interest rate	1.5	% 0.8	% 1.2	% 0.8	%
Average expected term (in years)	4.5	4.1	4.5	4.3	
Average expected volatility	31	% 35	% 30	% 33	%
Weighted average fair value at grant date	\$110.81	\$148.05	\$126.87	\$145.60	
<b>ESPP</b>					
Average risk free interest rate	0.2	% 0.2	% 0.2	% 0.2	%
Average expected term (in years)	1.3	1.3	1.3	1.3	
Average expected volatility	35	% 32	% 34	% 32	%
Weighted average fair value at grant date	\$115.84	\$143.36	\$153.33	\$138.61	

**NOTE 8. INCOME TAXES**

Income tax expense for the three month period ended September 30, 2013 was \$21.3 million, or 12.0% of pre-tax income, compared with \$32.4 million, or 15.0% of pre-tax income for the three month peri