

INTUITIVE SURGICAL INC  
Form 10-Q  
October 17, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

*(Mark One)*

**x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 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)  
**1266 Kifer Road**

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

**Sunnyvale, California 94086**

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(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 definition of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒

Accelerated filer ☐

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

Smaller Reporting company ☐

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

The Registrant had 39,113, 800 shares of Common Stock, \$0.001 par value per share, outstanding as of October 10, 2008.

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

|                                                                                                                                                                  | <b>September 30,<br/>2008</b> | <b>December 31,<br/>2007<br/>(See Note 2)</b> |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------|-----------------------------------------------|
| <b>ASSETS</b>                                                                                                                                                    |                               |                                               |
| Current assets:                                                                                                                                                  |                               |                                               |
| Cash and cash equivalents                                                                                                                                        | \$ 227,614                    | \$ 122,825                                    |
| Short-term investments                                                                                                                                           | 180,608                       | 304,642                                       |
| Accounts receivable, net                                                                                                                                         | 173,708                       | 130,370                                       |
| Inventory                                                                                                                                                        | 52,498                        | 32,416                                        |
| Prepays and other assets                                                                                                                                         | 11,285                        | 13,486                                        |
| Deferred tax assets                                                                                                                                              | 5,851                         | 5,852                                         |
| Total current assets                                                                                                                                             | 651,564                       | 609,591                                       |
| Property, plant and equipment, net                                                                                                                               | 98,081                        | 68,093                                        |
| Long-term investments                                                                                                                                            | 413,209                       | 207,914                                       |
| Long-term deferred tax assets                                                                                                                                    | 33,122                        | 18,725                                        |
| Intangible assets, net                                                                                                                                           | 57,582                        | 23,474                                        |
| Goodwill                                                                                                                                                         | 110,740                       | 110,740                                       |
| Other assets                                                                                                                                                     | 373                           | 1,461                                         |
| Total assets                                                                                                                                                     | \$ 1,364,671                  | \$ 1,039,998                                  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                      |                               |                                               |
| Current liabilities:                                                                                                                                             |                               |                                               |
| Accounts payable                                                                                                                                                 | \$ 26,159                     | \$ 29,791                                     |
| Accrued compensation and employee benefits                                                                                                                       | 29,720                        | 30,077                                        |
| Deferred revenue                                                                                                                                                 | 71,465                        | 53,817                                        |
| Other accrued liabilities                                                                                                                                        | 19,498                        | 18,085                                        |
| Total current liabilities                                                                                                                                        | 146,842                       | 131,770                                       |
| Deferred revenue                                                                                                                                                 | 1,336                         | 875                                           |
| Other accrued liabilities                                                                                                                                        | 33,065                        | 18,679                                        |
| Total liabilities                                                                                                                                                | 181,243                       | 151,324                                       |
| 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 September 30, 2008 and December 31, 2007 |                               |                                               |
|                                                                                                                                                                  | 39                            | 38                                            |

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Common stock, 100,000 shares authorized, \$0.001 par value, 39,114 and 38,470 shares issued and outstanding as of September 30, 2008 and December 31, 2007, respectively

|                                               |              |              |
|-----------------------------------------------|--------------|--------------|
| Additional paid-in capital                    | 847,215      | 694,597      |
| Retained earnings                             | 347,066      | 193,509      |
| Accumulated other comprehensive income (loss) | (10,892)     | 530          |
| Total stockholders' equity                    | 1,183,428    | 888,674      |
| Total liabilities and stockholders' equity    | \$ 1,364,671 | \$ 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)**

|                                              | <b>Three Months Ended<br/>September 30,<br/>2008</b> |            | <b>Nine Months Ended<br/>September 30,<br/>2008</b> |            |
|----------------------------------------------|------------------------------------------------------|------------|-----------------------------------------------------|------------|
|                                              | <b>2007</b>                                          |            | <b>2007</b>                                         |            |
| Revenue:                                     |                                                      |            |                                                     |            |
| Products                                     | \$ 202,267                                           | \$ 135,053 | \$ 552,998                                          | \$ 351,387 |
| Services                                     | 33,725                                               | 21,851     | 90,376                                              | 59,995     |
| Total revenue                                | 235,992                                              | 156,904    | 643,374                                             | 411,382    |
| Cost of revenue:                             |                                                      |            |                                                     |            |
| Products                                     | 53,517                                               | 38,305     | 148,405                                             | 103,067    |
| Services                                     | 12,900                                               | 10,129     | 39,532                                              | 29,229     |
| Total cost of revenue                        | 66,417                                               | 48,434     | 187,937                                             | 132,296    |
| Gross profit                                 | 169,575                                              | 108,470    | 455,437                                             | 279,086    |
| Operating expenses:                          |                                                      |            |                                                     |            |
| Selling, general, and administrative         | 62,692                                               | 40,163     | 168,830                                             | 112,989    |
| Research and development                     | 21,851                                               | 14,319     | 58,509                                              | 32,736     |
| Total operating expenses                     | 84,543                                               | 54,482     | 227,339                                             | 145,725    |
| Income from operations                       | 85,032                                               | 53,988     | 228,098                                             | 133,361    |
| Interest and other income, net               | 4,594                                                | 12,220     | 18,843                                              | 22,060     |
| Income before taxes                          | 89,626                                               | 66,208     | 246,941                                             | 155,421    |
| Income tax expense                           | 32,032                                               | 25,289     | 93,384                                              | 60,037     |
| Net income                                   | \$ 57,594                                            | \$ 40,919  | \$ 153,557                                          | \$ 95,384  |
| Earnings per share:                          |                                                      |            |                                                     |            |
| Basic                                        | \$ 1.48                                              | \$ 1.08    | \$ 3.96                                             | \$ 2.53    |
| Diluted                                      | \$ 1.44                                              | \$ 1.04    | \$ 3.84                                             | \$ 2.46    |
| Shares used in computing earnings per share: |                                                      |            |                                                     |            |
| Basic                                        | 39,015                                               | 38,033     | 38,790                                              | 37,653     |
| Diluted                                      | 40,108                                               | 39,271     | 39,978                                              | 38,776     |

See accompanying notes to condensed consolidated financial statements.



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

|                                                                                   | <b>Nine Months Ended<br/>September 30,</b> |                  |
|-----------------------------------------------------------------------------------|--------------------------------------------|------------------|
|                                                                                   | <b>2008</b>                                | <b>2007</b>      |
| <b>Operating Activities:</b>                                                      |                                            |                  |
| Net income                                                                        | \$ 153,557                                 | \$ 95,384        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                            |                  |
| Depreciation                                                                      | 10,687                                     | 8,016            |
| Amortization of intangible assets                                                 | 6,892                                      | 1,290            |
| Gain on sale of investments                                                       |                                            | (4,075)          |
| Deferred income taxes                                                             | (14,115)                                   | (5,344)          |
| Income tax benefits from employee stock option plans and acquisition              | 55,378                                     | 56,770           |
| Excess tax benefit from stock-based compensation                                  | (52,791)                                   | (47,145)         |
| Share-based compensation expense                                                  | 55,247                                     | 26,182           |
| Changes in operating assets and liabilities:                                      |                                            |                  |
| Accounts receivable                                                               | (43,340)                                   | (25,584)         |
| Inventory                                                                         | (20,102)                                   | (2,444)          |
| Prepays and other assets                                                          | 2,180                                      | (7,655)          |
| Accounts payable                                                                  | (3,605)                                    | 11,128           |
| Deferred revenue                                                                  | 18,109                                     | 11,184           |
| Accrued liabilities                                                               | 7,898                                      | 4,968            |
| <b>Net cash provided by operating activities</b>                                  | <b>175,995</b>                             | <b>122,675</b>   |
| <b>Investing Activities:</b>                                                      |                                            |                  |
| Purchase of investments                                                           | (586,436)                                  | (450,224)        |
| Proceeds from sales and maturities of investments                                 | 493,246                                    | 302,787          |
| Capital expenditures and acquisitions of intellectual property                    | (73,031)                                   | (12,172)         |
| <b>Net cash used in investing activities</b>                                      | <b>(166,221)</b>                           | <b>(159,609)</b> |
| <b>Financing Activities:</b>                                                      |                                            |                  |
| Proceeds from issuance of common stock, net                                       | 41,993                                     | 41,611           |
| Excess tax benefit from stock-based compensation                                  | 52,791                                     | 47,145           |
| <b>Net cash provided by financing activities</b>                                  | <b>94,784</b>                              | <b>88,756</b>    |
| Effect of exchange rate changes on cash and cash equivalents                      | 231                                        | 181              |
| <b>Net increase in cash and cash equivalents</b>                                  | <b>104,789</b>                             | <b>52,003</b>    |
| Cash and cash equivalents, beginning of period                                    | 122,825                                    | 34,390           |
| <b>Cash and cash equivalents, end of period</b>                                   | <b>\$ 227,614</b>                          | <b>\$ 86,393</b> |

See accompanying notes to condensed consolidated financial statements.



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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.

**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 rules and regulations of the Securities and Exchange Commission (SEC), and, therefore, omit certain information and footnote disclosure necessary to present the statements in accordance with 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 nine months of fiscal 2008 are not indicative of the results to be expected for the entire fiscal year or any future periods.

***Recent Accounting Pronouncements***

In April 2008, the FASB issued FSP No. 142-3, Determination of the Useful Life of Intangible Assets, (FSP No. 142-3) that amends the factors considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets (SFAS No. 142). FSP No. 142-3 requires a consistent approach between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of an asset under SFAS No. 141 (R), Business Combinations. The FSP also requires enhanced disclosures when an intangible asset's expected future cash flows are affected by an entity's intent and/or ability to renew or extend the arrangement. FSP No. 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and is applied prospectively. Early adoption is prohibited. The Company does not expect the adoption of FSP No. 142-3 to have a material impact on its consolidated results of operations or financial condition.

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 of 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. The adoption of this statement did not have a material impact on the Company's consolidated results of operations or financial condition. On October 10, 2008, the FASB issued FSP No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active, (FSP 157-3) that clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial assets is not active. The FSP 157-3 is

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applicable to the valuation of auction-rate securities held by the Company for which there was no active market as of September 30, 2008. FSP 157-3 is effective upon issuance, including prior periods for which the financial statements have not been issued. The adoption of FSP 157-3 during the three month period ending September 30, 2008 did not have a material impact on the Company's consolidated results of operations or financial condition.

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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. INVESTMENTS AND FAIR VALUE MEASUREMENTS***INVESTMENTS*

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

|                                       | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <b>September 30, 2008</b>             |                   |                              |                               |               |
| Short-term investments:               |                   |                              |                               |               |
| Commercial paper                      | \$ 16,867         | \$                           | \$ (60)                       | \$ 16,807     |
| Corporate debt                        | 93,359            | 289                          | (1,106)                       | 92,542        |
| U.S. Treasuries                       | 4,781             | 9                            |                               | 4,790         |
| U.S government agencies               | 66,542            | 18                           | (91)                          | 66,469        |
| Total short-term investments          | \$ 181,549        | \$ 316                       | \$ (1,257)                    | \$ 180,608    |
| Long-term investments:                |                   |                              |                               |               |
| Municipal bonds                       | \$ 99,859         | \$                           | \$ (8,304)                    | \$ 91,555     |
| Corporate debt                        | 142,203           | 269                          | (2,152)                       | 140,320       |
| U.S. Treasuries                       | 29,778            | 234                          |                               | 30,012        |
| U.S government agencies               | 151,619           | 174                          | (471)                         | 151,322       |
| Total long-term investments           | \$ 423,459        | \$ 677                       | \$ (10,927)                   | \$ 413,209    |
| Total short and long-term investments | \$ 605,008        | \$ 993                       | \$ (12,184)                   | \$ 593,817    |
| <b>December 31, 2007</b>              |                   |                              |                               |               |
| Short-term investments:               |                   |                              |                               |               |
| Commercial paper                      | \$ 43,953         | \$ 35                        | \$ (1)                        | \$ 43,987     |
| Municipal bonds                       | 156,250           |                              |                               | 156,250       |
| 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      |
| 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    |

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The following is a summary of the amortized cost and estimated fair value of investments at September 30, 2008 by maturity date (in thousands):

|                                | <b>Amortized<br/>Cost</b> | <b>Fair<br/>Value</b> |
|--------------------------------|---------------------------|-----------------------|
| Mature in less than one year   | \$ 181,549                | \$ 180,608            |
| Mature in one to five years    | 328,609                   | 326,610               |
| Mature in more than five years | 94,850                    | 86,599                |
| <br>Total                      | <br>\$ 605,008            | <br>\$ 593,817        |

For the three and nine months ended September 30, 2008, realized gains or losses recognized on the sale of investments were not material. During the three and nine months ended September 30, 2007, the Company realized gains of approximately \$4.1 million on the sale of publicly-traded equity securities. As of September 30, 2008 and December 31, 2007, unrealized gain (loss) on available-for-sale securities, net of tax, of (\$11.2) million and \$0.4 million, respectively, were included in accumulated other comprehensive income (loss) in the accompanying unaudited Condensed Consolidated Balance Sheets. At September 30, 2008, the Company evaluated its net unrealized losses, the majority of which are from auction-rate securities, and determined them to be temporary. Factors considered in determining whether a loss is temporary included the length of time and extent to which the investments fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, and the Company's intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in fair value.

***FAIR VALUE MEASUREMENTS***

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.

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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 September 30, 2008 (in thousands):

|                           | Fair Value Measurements at Reporting Date Using |                   |                  |                   |
|---------------------------|-------------------------------------------------|-------------------|------------------|-------------------|
|                           | Level 1                                         | Level 2           | Level 3          | Total             |
| Money Market funds        | \$ 89,138                                       |                   | \$               | \$ 89,138         |
| Commercial paper          |                                                 | 64,328            |                  | 64,328            |
| Municipal bonds           |                                                 | 4,957             | 86,599           | 91,556            |
| Corporate debt            |                                                 | 232,861           |                  | 232,861           |
| U.S. Treasuries           |                                                 | 34,800            |                  | 34,800            |
| U.S. government agencies  |                                                 | 217,793           |                  | 217,793           |
| <b>Total</b>              | <b>\$ 89,138</b>                                | <b>\$ 554,739</b> | <b>\$ 86,599</b> | <b>\$ 730,476</b> |
| Amounts included in:      |                                                 |                   |                  |                   |
| Cash and cash equivalents | \$ 89,138                                       | \$ 47,521         | \$               | \$ 136,659        |
| Short-term investments    |                                                 | 180,608           |                  | 180,608           |
| Long-term investments     |                                                 | 326,610           | 86,599           | 413,209           |
| <b>Total</b>              | <b>\$ 89,138</b>                                | <b>\$ 554,739</b> | <b>\$ 86,599</b> | <b>\$ 730,476</b> |

Level 3 assets consist of municipal bonds with an auction reset feature ( auction rate securities or ARS ) whose underlying assets are student loans which are substantially backed by the federal government. Auction-rate securities are long-term floating rate bonds tied to short-term interest rates. After the initial issuance of the securities, the interest rate on the securities is reset periodically, at intervals established at the time of issuance (primarily every twenty-eight days), based on market demand for a reset period. Auction-rate securities are bought and sold in the marketplace through a competitive bidding process often referred to as a Dutch auction. If there is insufficient interest in the securities at the time of an auction, the auction may not be completed and the rates may be reset to predetermined penalty or maximum rates based on mathematical formulas in accordance with each security's prospectus.

In February 2008, auctions began to fail for these securities and each auction since then has failed. Consequently, the investments are not currently liquid. All but one of our ARS are currently rated AAA, the highest rating, by a rating agency. The Company does not expect to need to access these funds in the short-term; however, in the event the Company needed to access these funds, they are not expected to be accessible until one of the following occurs: a successful auction occurs, the issuer redeems the issue, a buyer is found outside of the auction process or the underlying securities mature. In October 2008, the Company received an offer (the Offer ) from UBS AG ( UBS ), one of its investment providers, to sell at par value auction-rate securities originally purchased from UBS (approximately \$71 million) at anytime during a two-year period beginning June 30, 2010. The Offer is non-transferable and expires on November 14, 2008. The acceptance of the Offer will likely result in a charge to income for the difference between the fair value of the Offer and the unrealized loss on the auction rate securities held (\$6.0 million at September 30, 2008 related to the auction-rate securities held by UBS). The Company is in the process of evaluating the Offer and its potential financial statements impact. Based on this, along with the underlying maturities of the securities, a portion of which is greater than 30 years, we have classified auction rate securities as long-term assets on our condensed consolidated balance sheet.

Typically, the fair value of ARS investments approximates par value due to the frequent resets through the auction process. While the Company continues to earn interest on its ARS investments at the contractual rate, these investments are not currently trading and therefore do not have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximates par value. At September 30, 2008, the Company's investment advisors provided a valuation based on Level 3 inputs for the ARS investments. The investment advisors utilized a discounted cash flow approach to arrive at this valuation, which was corroborated by a separate and comparable discounted cash flow analysis prepared by the Company. The assumptions used in preparing the discounted cash flow model include estimates of, based on data available as of September 30, 2008, interest rates, timing and amount of cash flows, credit and liquidity premiums, and expected holding periods of the ARS. These assumptions are volatile and subject to change as the underlying sources of these assumptions and market conditions change. Based on this Level 3 valuation, the Company valued the ARS investments at \$86.6 million, which represents a decline in value of \$8.3 million from par.

Although there is uncertainty with regard to the short-term liquidity of these securities, the Company continues to believe that the carrying value represents the fair value of these marketable securities because of the overall quality of the underlying investments and the anticipated future market for such investments. In addition, the Company has the intent and ability to hold these securities until the earlier of: the market for

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auction rate securities stabilizes, the issuer refinances the underlying security, a buyer is found outside of the auction process at acceptable terms, the underlying securities have matured or the Company accepts the investment manager's offer to redeem the securities.

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Based on the cash and short-term marketable securities balance of \$408.2 million and expected positive operating cash flows, the Company does not anticipate that the lack of liquidity associated with the auction rate securities will adversely affect the Company's ability to conduct its business, and the Company has the ability to hold the securities throughout the currently estimated recovery period. The Company will continue to evaluate any changes in the market value of the failed auction rate securities that have not been liquidated subsequent to quarter-end. Depending upon future market conditions, the Company may be required to record an other-than-temporary decline in market value at that time.

The following table provides a reconciliation of the beginning and ending balances for the assets measured at fair value using significant unobservable inputs (Level 3) (in thousands):

|                                                        | <b>Fair Value Measurements at Reporting Date Using significant Unobservable Inputs (Level 3)</b> |          |
|--------------------------------------------------------|--------------------------------------------------------------------------------------------------|----------|
|                                                        | <b>Level 3 Financial Assets</b>                                                                  |          |
| Balance at January 1, 2008                             | \$                                                                                               | 158,262  |
| Unrealized loss included in other comprehensive income |                                                                                                  | (4,427)  |
| Purchases                                              |                                                                                                  | 20,150   |
| Sales/Maturities                                       |                                                                                                  | (83,262) |
| Balance at March 31, 2008                              |                                                                                                  | 90,723   |
| Unrealized loss included in other comprehensive income |                                                                                                  | (1,634)  |
| Balance at June 30, 2008                               |                                                                                                  | 89,089   |
| Unrealized loss included in other comprehensive income |                                                                                                  | (2,190)  |
| Sales/Maturities                                       |                                                                                                  | (300)    |
| Balance at September 30, 2008                          | \$                                                                                               | 86,599   |

**NOTE 4. BALANCE SHEET DETAILS**

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

|                 | <b>September 30, 2008</b> | <b>December 31, 2007</b> |
|-----------------|---------------------------|--------------------------|
| Inventory       |                           |                          |
| Raw materials   | \$ 18,743                 | \$ 12,809                |
| Work-in-process | 5,209                     | 3,257                    |
| Finished goods  | 28,546                    | 16,350                   |
| Total           | \$ 52,498                 | \$ 32,416                |

**Table of Contents****NOTE 5. STOCKHOLDERS' EQUITY*****Comprehensive Income***

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

|                                                                               | <b>Three Months Ended<br/>September 30,</b> |                  | <b>Nine Months Ended<br/>September 30,</b> |                  |
|-------------------------------------------------------------------------------|---------------------------------------------|------------------|--------------------------------------------|------------------|
|                                                                               | <b>2008</b>                                 | <b>2007</b>      | <b>2008</b>                                | <b>2007</b>      |
| Net income, as reported                                                       | \$ 57,594                                   | \$ 40,919        | \$ 153,557                                 | \$ 95,384        |
| Other comprehensive income:                                                   |                                             |                  |                                            |                  |
| Foreign currency translation adjustments                                      | (282)                                       | (21)             | 229                                        | (18)             |
| Change in unrealized gain (loss) on available-for-sale securities, net of tax | (4,871)                                     | (1,001)          | (11,651)                                   | (487)            |
| <b>Comprehensive income</b>                                                   | <b>\$ 52,441</b>                            | <b>\$ 39,897</b> | <b>\$ 142,135</b>                          | <b>\$ 94,879</b> |

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

|                                                                                     | <b>September 30,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|-------------------------------------------------------------------------------------|-------------------------------|------------------------------|
| Accumulated net unrealized gain (loss) on available-for-sale securities, net of tax | \$ (11,239)                   | \$ 412                       |
| Foreign currency translation adjustments                                            | 347                           | 118                          |
| <b>Total accumulated other comprehensive income (loss)</b>                          | <b>\$ (10,892)</b>            | <b>\$ 530</b>                |

***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.

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A summary of stock option activity under the Plans for the nine months ended September 30, 2008 is presented as follows:

|                                                                                                                              | Shares<br>Available<br>for Grant | Stock Options Outstanding<br>Number<br>Outstanding | Weighted Average<br>Exercise Price<br>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 authorized                                                                                                           | 2,094,843                        |                                                    |                                                 |
| Options granted                                                                                                              | (1,303,590)                      | 1,303,590                                          | 298.88                                          |
| Options exercised                                                                                                            |                                  | (555,665)                                          | 59.60                                           |
| Options forfeited/expired                                                                                                    | 114,658                          | (115,428)                                          | 219.02                                          |
| Balance at September 30, 2008 (with 1,617,311 options exercisable at a weighted-average exercise price of \$87.00 per share) | 8,501,643                        | 3,768,728                                          | \$ 161.30                                       |

### Employee Stock Purchase Plan (ESPP)

Under the Employee Stock Purchase Plan, employees purchased approximately 39,100 shares for \$4.3 million and 85,850 shares for \$8.9 million during the three and nine months ended September 30, 2008, respectively and 36,000 shares for \$2.8 million and 104,000 shares for \$6.1 million during the three and nine months ended September 30, 2007, respectively.

### Stock-based Compensation

The following table summarizes stock-based compensation charges:

|                                                            | Three Months Ended<br>September 30,<br>2008 |          | September 30,<br>2007 |           |
|------------------------------------------------------------|---------------------------------------------|----------|-----------------------|-----------|
| Cost of sales - products                                   | \$ 1,722                                    | \$ 859   | \$ 4,627              | \$ 2,466  |
| Cost of sales - services                                   | 1,378                                       | 550      | 3,648                 | 1,649     |
| Total cost of sales                                        | 3,100                                       | 1,409    | 8,275                 | 4,115     |
| Selling, general and administrative                        | 13,197                                      | 5,210    | 34,567                | 16,244    |
| Research and development                                   | 4,668                                       | 2,107    | 12,405                | 5,823     |
| Stock-based compensation expense before income tax benefit | 20,965                                      | 8,726    | 55,247                | 26,182    |
| Income tax benefit                                         | 7,491                                       | 3,070    | 19,838                | 9,196     |
| Stock-based compensation expense after income taxes        | \$ 13,474                                   | \$ 5,656 | \$ 35,409             | \$ 16,986 |

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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:

|                                           | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|-------------------------------------------|-------------------------------------|----------|------------------------------------|----------|
|                                           | 2008                                | 2007     | 2008                               | 2007     |
| <b>Stock Options</b>                      |                                     |          |                                    |          |
| Average risk free interest rate           | 3.20%                               | 4.68%    | 2.82%                              | 4.68%    |
| Average expected term (years)             | 5.4                                 | 5.0      | 5.0                                | 5.2      |
| Average expected volatility               | 49%                                 | 37%      | 51%                                | 36%      |
| Weighted average fair value at grant date | \$ 131.45                           | \$ 74.68 | \$ 142.01                          | \$ 49.82 |
| <b>ESPP</b>                               |                                     |          |                                    |          |
| Average risk free interest rate           | 2.24%                               | 4.76%    | 2.18%                              | 4.96%    |
| Average expected term (years)             | 1.3                                 | 1.3      | 1.3                                | 1.3      |
| Average expected volatility               | 50%                                 | 37%      | 54%                                | 39%      |
| Weighted average fair value at grant date | \$ 115.13                           | \$ 69.46 | \$ 108.08                          | \$ 51.40 |

**NOTE 6. 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 three months ended September 30, 2008 was \$32.0 million, or 35.7% of pre-tax income, compared with \$25.3 million, or 38.2% of pre-tax income for the three months ended September 30, 2007. Income tax expense for the nine months ended September 30, 2008 was \$93.4 million, or 37.8% of pre-tax income, compared with \$60.0 million, or 38.6% of pre-tax income for the nine months ended September 30, 2007. The effective tax rate for the three and nine months ended September 30, 2008 differs from the U.S. federal statutory rate of 35% primarily due to state income taxes, partially offset by 2008 California research and development (R&D) credits, domestic production deductions and a \$3.1 million increase in 2007 R&D credits recorded after the Company's 2007 tax returns were filed in September 2008. The effective tax rate for the three and nine months ended September 30, 2007 differs from the federal statutory rate primarily due to state income taxes, partially offset by R&D credits.

As of September 30, 2008, the Company has total gross unrecognized tax benefits of approximately \$34.3 million compared with approximately \$22.0 million as of December 31, 2007, representing an increase of approximately \$12.3 million for the first nine months of fiscal 2008. Of the total gross unrecognized tax benefits, \$29.0 million, if recognized, would reduce our effective tax rate in the period of recognition. Interest and penalties are insignificant and are included in tax expense.

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 limitations currently remain open for all years since inception due to utilization of net operating losses and R&D credits generated in prior years.

On October 3, 2008, the *Emergency Economic Stabilization Act of 2008, Energy Improvement and Extension Act of 2008 and Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (HR1424)* was signed into law, which, as enacted, includes a provision that retroactively extends the research tax credit to January 1, 2008, for two years. The Company has not yet completed its analysis of the 2008 benefit which will be recognized in the fourth quarter of fiscal 2008.

On September 23, 2008, a 2008-2009 budget legislation that contains significant California State tax law changes was signed into law. Under the new law, for tax years 2008 and 2009, taxpayers may not use certain business tax credits to reduce their tax liability below 50% of their net tax amount, before application of any credits. The carryover period of any credit not allowed as a result of this limitation is increased by the number of taxable years the credit (or any portion thereof) is not allowed. The immediate impact in the current tax year for the Company is a limitation on the R&D tax credit that the Company will be able to utilize. The Company does not expect this change to impact its income tax expense.



**Table of Contents****NOTE 7. NET INCOME PER SHARE**

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

|                                                                         | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|-------------------------------------------------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                                                         | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|                                                                         | <b>2008</b>               | <b>2007</b> | <b>2008</b>              | <b>2007</b> |
| Net income                                                              | \$ 57,594                 | \$ 40,919   | \$ 153,557               | \$ 95,384   |
| Basic:                                                                  |                           |             |                          |             |
| Weighted-average shares outstanding                                     | 39,015                    | 38,033      | 38,790                   | 37,653      |
| Basic net income per share                                              | \$ 1.48                   | \$ 1.08     | \$ 3.96                  | \$ 2.53     |
| Diluted:                                                                |                           |             |                          |             |
| Weighted-average shares outstanding used in basic calculation           | 39,015                    | 38,033      | 38,790                   | 37,653      |
| Add common stock equivalents                                            | 1,093                     | 1,238       | 1,188                    | 1,123       |
| Weighted-average shares used in computing diluted net income per shares | 40,108                    | 39,271      | 39,978                   | 38,776      |
| Diluted earnings per share                                              | \$ 1.44                   | \$ 1.04     | \$ 3.84                  | \$ 2.46     |

Employee stock options to purchase approximately 1,340,400 and 64,000 weighted shares for the three months ended September 30, 2008 and 2007, respectively, and 1,089,100 and 844,000 weighted shares for the nine months ended September 30, 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.

**NOTE 8. SUBSEQUENT EVENTS**

In October 2008, the Company received an Offer from UBS, one of its investment providers, to sell at par value auction-rate securities originally purchased from UBS (approximately \$71 million) at anytime during a two-year period beginning June 30, 2010. The Offer is non-transferable and expires on November 14, 2008. The acceptance of the Offer will likely result in a charge to income for the difference between the fair value of the Offer and the unrealized loss on the auction rate securities held (\$6.0 million at September 30, 2008 related to the auction-rate securities held by UBS). The Company is in the process of evaluating the Offer and its potential financial statements impact.

**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 September 30, 2008 and results of operations for the three and nine months ended September 30, 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

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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*, *EndoWrist®*, *InSite®*, *3DHD*, *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 September 30, 2008 was \$109.7 million or 46% of total revenue and for the nine months ended September 30, 2008 was \$301.8 million, or 47% of total revenue. We expect recurring revenue to become a larger percentage of total revenue in the future.

## Regulatory Clearances

We believe that we have obtained clearances required to market our products to our targeted surgical specialties within the United States. As we make additions to the 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

## **Table of Contents**

March 2001    Non-cardiac thoroscopic 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

In March 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 third 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.

## **Third Quarter 2008 Financial Highlights**

Total revenue grew 50% to \$236.0 million from \$156.9 million during the third quarter of 2007.

Recurring revenue grew 54% to \$109.7 million from \$71.4 million during the third quarter of 2007.

Instruments and accessories revenue grew 53% to \$75.9 million from \$49.5 million during the third quarter of 2007.

We sold 91 *da Vinci* Surgical Systems during the third quarter of 2008, an increase of 44% compared with 63 in the third quarter of 2007.

As of September 30, 2008, we had a *da Vinci* Surgical System installed base of 1,032 systems, 776 in North America, 171 in Europe, and 85 in the rest of the world.

Operating income increased by 58% to \$85.0 million, or 36% of revenue, during the third quarter of 2008 from \$54.0 million, or 34% of revenue, during the third quarter of 2007. Operating income included \$21.0 million and \$8.7 million during the third quarter of 2008 and 2007, respectively, of stock-based compensation expense for the estimated fair 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 \$81.6 million, net of \$21.0 million of capital expenditure for land, buildings, intellectual property rights and other items, from the second quarter of 2008, as we ended the third quarter of 2008 with \$821.4 million in cash, cash equivalents, and investments.

**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 at least 30% from 2007 to 2008 and dVH procedures are expected to grow at least 150% from 2007 to 2008. Other urologic procedures such as nephrectomies, cystectomies and pyeloplasties, other gynecologic procedures such as myomectomies and sacral colpopexies, cardiothoracic procedures such as mitral valve repair and cardiac revascularization have also contributed to our growth. dVP and dVH represented approximately 79% of the procedures performed during the nine months ended September 30, 2008 and no other procedure represents a significant part of our business at this time.

**Table of Contents****New Products**

During the third quarter of 2008, we launched the *EndoWrist* Grasping Retractor. The *EndoWrist* Grasping Retractor is a multi-functional 8mm instrument to facilitate soft tissue management. The *EndoWrist* Grasping Retractor is designed with the primary intent of providing an atraumatic, large profile, multi-functional instrument for grasping and retracting abdominal viscera and peritoneal tissue in a totally endoscopic environment, in order to obtain the necessary exposure during pelvic and abdominal procedures. The *EndoWrist* Grasping Retractor is used in procedures such as hysterectomy for cancer with lymphadenectomy, sacrocolpopexy, and low anterior resection.

**RESULTS OF OPERATIONS**

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

|                                      | Three months Ended September 30, |                    |            |                    | Nine months Ended September 30, |                    |            |                    |
|--------------------------------------|----------------------------------|--------------------|------------|--------------------|---------------------------------|--------------------|------------|--------------------|
|                                      | 2008                             | % of total revenue | 2007       | % of total revenue | 2008                            | % of total revenue | 2007       | % of total revenue |
| Revenue:                             |                                  |                    |            |                    |                                 |                    |            |                    |
| Products                             | \$ 202,267                       | 86%                | \$ 135,053 | 86%                | \$ 552,998                      | 86%                | \$ 351,387 | 85%                |
| Services                             | 33,725                           | 14%                | 21,851     | 14%                | 90,376                          | 14%                | 59,995     | 15%                |
| Total revenue                        | 235,992                          | 100%               | 156,904    | 100%               | 643,374                         | 100%               | 411,382    | 100%               |
| Cost of revenue:                     |                                  |                    |            |                    |                                 |                    |            |                    |
| Products                             | 53,517                           | 23%                | 38,305     | 24%                | 148,405                         | 23%                | 103,067    | 25%                |
| Services                             | 12,900                           | 5%                 | 10,129     | 6%                 | 39,532                          | 6%                 | 29,229     | 7%                 |
| Total cost of revenue                | 66,417                           | 28%                | 48,434     | 31%                | 187,937                         | 29%                | 132,296    | 32%                |
| Products gross profit                | 148,750                          | 63%                | 96,748     | 62%                | 404,593                         | 63%                | 248,320    | 60%                |
| Services gross profit                | 20,825                           | 9%                 | 11,722     | 7%                 | 50,844                          | 8%                 | 30,766     | 7%                 |
| Gross profit                         | 169,575                          | 72%                | 108,470    | 69%                | 455,437                         | 71%                | 279,086    | 68%                |
| Operating expenses:                  |                                  |                    |            |                    |                                 |                    |            |                    |
| Selling, general, and administrative | 62,692                           | 27%                | 40,163     | 26%                | 168,830                         | 26%                | 112,989    | 27%                |
| Research and development             | 21,851                           | 9%                 | 14,319     | 9%                 | 58,509                          | 10%                | 32,736     | 8%                 |
| Total operating expenses             | 84,543                           | 36%                | 54,482     | 35%                | 227,339                         | 36%                | 145,725    | 35%                |
| Income from operations               | 85,032                           | 36%                | 53,988     | 34%                | 228,098                         | 35%                | 133,361    | 32%                |
| Interest and other income, net       | 4,594                            | 2%                 | 12,220     | 8%                 | 18,843                          | 3%                 | 22,060     | 5%                 |
| Income before taxes                  | 89,626                           | 38%                | 66,208     | 42%                | 246,941                         | 38%                | 155,421    | 38%                |
| Income tax expense                   | 32,032                           | 14%                | 25,289     | 16%                | 93,384                          | 14%                | 60,037     | 15%                |
| Net income                           | \$ 57,594                        | 24%                | \$ 40,919  | 26%                | \$ 153,557                      | 24%                | \$ 95,384  | 23%                |

**Total Revenue**

Total revenue increased to \$236.0 million for the three months ended September 30, 2008 from \$156.9 million for the three months ended September 30, 2007. For the nine months ended September 30, 2008, revenue increased to \$643.4 million from \$411.4 million for the nine months ended September 30, 2007. First nine months of 2008 revenue growth was driven by the continued adoption of *da Vinci* surgery. We

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believe that robotic surgery will be adopted surgical procedure by surgical procedure. Our revenue growth during the periods presented reflects adoption progress made in all of our target procedures. 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 nine months of 2008, 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, a minimally invasive approach using the *da Vinci* Surgical System offers reduced pain, less blood loss, shorter hospital stays, reduced post-operation complications and a quicker return to normal daily activities.

Revenue within the United States accounted for 81% and 79% of total revenue for the three and nine month periods ended September 30, 2008, respectively, and 78% and 80% of total revenue for the three and nine month periods ended September 30, 2007, respectively. We believe domestic revenue accounts for the large majority of total revenue primarily due to the competitive nature of the domestic healthcare market and pronounced seasonal slowdown overseas.

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The following table summarizes our revenue and *da Vinci* Surgical System unit sales for the three and nine month periods ended September 30, 2008 and 2007 (in thousands, except percentages and unit sales):

|                                                   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---------------------------------------------------|-------------------------------------|------------|------------------------------------|------------|
|                                                   | 2008                                | 2007       | 2008                               | 2007       |
| <b>Revenue</b>                                    |                                     |            |                                    |            |
| Instruments and accessories                       | \$ 75,941                           | \$ 49,491  | \$ 211,414                         | \$ 135,556 |
| Systems                                           | 126,326                             | 85,562     | 341,584                            | 215,831    |
| Total product revenue                             | 202,267                             | 135,053    | 552,998                            | 351,387    |
| Services and training                             | 33,725                              | 21,851     | 90,376                             | 59,995     |
| Total revenue                                     | \$ 235,992                          | \$ 156,904 | \$ 643,374                         | \$ 411,382 |
| Recurring revenue                                 | \$ 109,666                          | \$ 71,342  | \$ 301,790                         | \$ 195,551 |
| % of total revenue                                | 46%                                 | 45%        | 47%                                | 48%        |
| Domestic                                          | \$ 191,071                          | \$ 123,111 | \$ 510,145                         | \$ 329,730 |
| International                                     | 44,921                              | 33,793     | 133,229                            | 81,652     |
| Total revenue                                     | \$ 235,992                          | \$ 156,904 | \$ 643,374                         | \$ 411,382 |
| % of Domestic Revenue                             | 81%                                 | 78%        | 79%                                | 80%        |
| % of International Revenue                        | 19%                                 | 22%        | 21%                                | 20%        |
| <b><u>da Vinci Surgical System Unit Sales</u></b> |                                     |            |                                    |            |
| <i>da Vinci</i> S HD                              | 76                                  | 43         | 206                                | 102        |
| <i>da Vinci</i> S 4-arm                           | 11                                  | 13         | 28                                 | 47         |
| <i>da Vinci</i> S 3-arm                           | 2                                   | 4          | 9                                  | 4          |
| standard <i>da Vinci</i> 3 arm                    | 0                                   | 1          | 2                                  | 4          |
| standard <i>da Vinci</i> 4 arm                    | 2                                   | 2          | 5                                  | 6          |
|                                                   | 91                                  | 63         | 250                                | 163        |
| Domestic Unit Sales                               | 71                                  | 46         | 191                                | 122        |
| International Unit Sales                          | 20                                  | 17         | 59                                 | 41         |
| <b>Product Revenue</b>                            |                                     |            |                                    |            |

Product revenue increased 50% to \$202.3 million for the three months ended September 30, 2008 compared with \$135.1 million for the three months ended September 30, 2007.

Instruments and accessories revenue increased 53% to \$75.9 million for the three months ended September 30, 2008 compared with \$49.5 million for the three months ended September 30, 2007. The increase in revenue is driven by an increase in procedures performed. Procedure growth occurred in all of our targeted procedures with prostatectomy and hysterectomy being the largest drivers of growth. Utilization per installed system for the three months ended September 30, 2008 also increased as compared with the three months ended September 30, 2007.

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Systems revenue increased 48% to \$126.3 million during the three months ended September 30, 2008 compared with \$85.6 million during the three months ended September 30, 2007. The increase is primarily due to the growth in the number of system unit sales (91 compared with 63), reflecting adoption of robotic surgery; the increase in the average selling price ( ASP ) (\$1.37 million compared with \$1.33 million) resulting from a higher mix of the higher priced *da Vinci S* HD Surgical Systems and favorable foreign exchange impact of Euro-denominated sales.

Product revenue increased 57% to \$553.0 million for the nine months ended September 30, 2008 compared with \$351.4 million for the nine months ended September 30, 2007.

Instruments and accessories revenue increased 56% to \$211.4 million for the nine months ended September 30, 2008 compared with \$135.6 million for the nine months ended September 30, 2007. The increase for the nine months ended September 30, 2008 is the result of the same factors as the three months ended September 30, 2008.

Systems revenue increased 58% to \$341.6 million during the nine months ended September 30, 2008 compared with \$215.8 million during the nine months ended September 30, 2007. The increase is primarily due to the growth in the number of system unit sales (250 compared with 163), reflecting adoption of robotic surgery; the increase in the ASP (\$1.35 million compared with \$1.3 million) resulting from a higher mix of the higher priced *da Vinci S* HD surgical systems and favorable foreign exchange impact of Euro-denominated sales.

### ***Service Revenue***

Service revenue, comprised primarily of system service, increased 54% to \$33.7 million for the three months ended September 30, 2008 compared with \$21.9 million for the three months ended September 30, 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 third quarter of 2008 was driven by a larger base of *da Vinci* Surgical Systems producing contract service revenue and higher revenue for service provided outside of contracts. There were approximately 946 and 656 systems installed, entering the third quarter of 2008 and 2007, respectively, generating an average of \$36,000 and \$33,000 per system for each quarter, respectively.

Service revenue increased 51% to \$90.4 million for the nine months ended September 30, 2008 compared with \$60.0 million for the nine months ended September 30, 2007. Higher first nine months of 2008 service revenue was driven by a larger base of *da Vinci* Surgical Systems producing contract service revenue.

### ***Gross Profit***

Product gross profit during the three and nine month periods ended September 30, 2008 was \$148.8 million, or 74% of product revenue, and \$404.6 million, or 73% of product revenue, respectively, compared with \$96.7 million, or 72% of product revenue, and \$248.3 million, or 71% of product revenue, during the three and nine months ended September 30, 2007, respectively. The higher 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 ASP and instrument and system material cost reductions.

Service gross profit during the three and nine month periods ended September 30, 2008 was \$20.8 million, or 62% of service revenue, and \$50.8 million, or 56% of service revenue, respectively, compared with \$11.7 million, or 54% of service revenue, and \$30.8 million, or 51% of service revenue, during the three and nine month periods ended September 30, 2007, respectively. The higher 2008 service gross profit was driven by a larger installed base. The higher 2008 gross service profit percentage was driven by leveraging service costs across a larger base of installed systems and lower service parts consumption and repair costs per system.

### ***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 September 30, 2008 increased 56% to \$62.7 million compared with \$40.2 million for the three months ended September 30, 2007. Selling, general and administrative expenses for the nine months ended September 30, 2008 increased 49% to \$168.8 million compared with \$113.0 million for the nine months ended September 30, 2007. The increases are 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. Stock-based compensation expense increased by approximately \$8.0 million and \$18.3 million during the three and nine months ended September 30, 2008, respectively.



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### ***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.

Research and development expenses for the three months ended September 30, 2008 increased 53% to \$21.9 million compared with \$14.3 million for the three months ended September 30, 2007. Research and development expenses for the nine months ended September 30, 2008 increased 79% to \$58.5 million compared with \$32.7 million for the nine months ended September 30, 2007. The increases are due to the growth in our research and development organization, costs associated with co-development arrangements with industry partners, higher prototype expenses, the amortization of intellectual property rights and stock-based compensation expense. Stock-based compensation expense increased by approximately \$2.6 million and \$6.6 million during the three and nine months ended September 30, 2008, respectively. We expect to continue to make substantial investments in research and development and anticipate that research and development expense, including the aforementioned co-development arrangements with industry partners, will continue to increase in the future.

### ***Interest and Other Income, Net***

Interest and other income, net for the three months ended September 30, 2008 was \$4.6 million compared with \$12.2 million for the three months ended September 30, 2007. The decline of \$7.6 million during the three months ended September 30, 2008 was due to foreign exchange loss of \$1.5 million during the three months ended September 30, 2008, compared with a foreign exchange gain of \$1.8 million and a non-recurring gain on sale of equity securities of \$4.1 million recorded during the three months ended September 30, 2007. In addition, we earned lower interest income on our cash and investment balances. Our foreign exchange loss during the three months ended September 30, 2008 was primarily due to the impact of the strengthening US dollar on Euro-based cash and accounts receivable balances, compared to gains resulting from a weakening US dollar in the prior year.

Interest and other income, net for the nine months ended September 30, 2008 was \$18.8 million, which was \$3.2 million less than \$22.0 million recorded for the nine months ended September 30, 2007. The decline was primarily due to the non-recurring gain from sales of equity securities of \$4.1 million recorded during the nine months ended September 30, 2007. In addition, we recorded a foreign exchange loss of \$0.4 million during the nine months ended September 30, 2008 compared with a foreign exchange gain of \$2.2 million during the nine months ended September 30, 2007. We also had higher interest earned of \$3.1 million during the nine months ended September 30, 2008 compared with the same period in 2007.

In October 2008, we received an offer (the "Offer") from UBS AG ("UBS"), one of our investment providers, to sell at par value auction-rate securities originally purchased from UBS (approximately \$71 million) at anytime during a two-year period beginning June 30, 2010. The Offer is non-transferable and expires on November 14, 2008. The acceptance of the Offer will likely result in a charge to income for the difference between the fair value of the Offer and the unrealized loss on the auction rate securities held (\$6.0 million at September 30, 2008 related to the auction-rate securities held by UBS). We are in the process of evaluating the Offer and its potential financial statements impact.

### ***Income Tax Expense***

Income tax expense for the three months ended September 30, 2008 was \$32.0 million, or 35.7% of pre-tax income, compared with \$25.3 million, or 38.2% of pre-tax income for the three months ended September 30, 2007. Income tax expense for the nine months ended September 30, 2008 was \$93.4 million, or 37.8% of pre-tax income, compared with \$60.0 million, or 38.6% of pre-tax income for the nine months ended September 30, 2007. The effective tax rate for the three and nine months ended September 30, 2008 differs from the U.S. federal statutory rate of 35% primarily due to state income taxes, partially offset by 2008 California research and development (R&D) credits, domestic production deductions and a \$3.1 million increase in 2007 R&D credits recorded after our 2007 tax returns were filed in September 2008. The effective tax rate for the three and nine months ended September 30, 2007 differs from the federal statutory rate 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 \$120.0 million of employee stock option tax deductions have been generated in the nine months ended September 30, 2008. As a result, we estimate that our cash outlay for income taxes in fiscal year 2008 will be approximately 20% of pre-tax income.

On October 3, 2008, the *Emergency Economic Stabilization Act of 2008, Energy Improvement and Extension Act of 2008 and Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (HRI424)* was signed into law, which, as enacted, includes a provision that retroactively extends the research tax credit to January 1, 2008, for two years. We have not yet completed our analysis of the 2008 benefit which will be recognized in the fourth quarter of fiscal 2008.



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On September 23, 2008, 2008-2009 budget legislation that contains significant California State tax law changes was signed. Under the new law, for tax years 2008 and 2009, taxpayers may not use certain business tax credits to reduce their tax liability below 50% of their net tax amount, before application of any credits. The carryover period of any credit not allowed as a result of this limitation is increased by the number of taxable years the credit (or any portion thereof) is not allowed. The immediate impact in the current tax year for us is a limitation on the R&D tax credit that we will be able to utilize. We do not expect this change to impact our income tax expense.

**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 \$821.4 million at September 30, 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**

|                                                       | <b>Nine Months Ended<br/>September 30,</b> |             |
|-------------------------------------------------------|--------------------------------------------|-------------|
|                                                       | <b>2008</b>                                | <b>2007</b> |
|                                                       | <b>(in thousands)</b>                      |             |
| Net cash provided by (used in)                        |                                            |             |
| Operating activities                                  | \$ 175,995                                 | \$ 122,675  |
| Investing activities                                  | (166,221)                                  | (159,609)   |
| Financing activities                                  | 94,784                                     | 88,756      |
| Effect of exchange rates on cash and cash equivalents | 231                                        | 181         |
| Net increase in cash and cash equivalents             | \$ 104,789                                 | \$ 52,003   |

**Operating Activities**

For the nine months ended September 30, 2008, cash flow from operating activities of \$176.0 million exceeded our net income of \$153.6 million. For the nine months ended September 30, 2007 cash flow from operating activities of \$122.7 million exceeded our net income of \$95.4 million due to:

1. Non-cash charges to our net income in the form of stock-based compensation, amortization of intangible assets, taxes, and depreciation. These non-cash charges totaled \$61.3 million and \$35.7 million during the nine months ended September 30, 2008 and 2007 respectively.
2. Partially offset by \$38.9 million and \$8.4 million of increases in working capital for the nine months ended September 30, 2008 and 2007 respectively. Working capital is comprised primarily of accounts receivable, inventory, deferred revenue and other current liabilities.

Accounts receivable increased by \$43.3 million or 33% during the nine months ended September 30, 2008 compared with an increase of \$25.6 million or 27% for the nine months ended September 30, 2007 reflecting increased revenue and the timing of system sales.

Inventory increased by \$20.1 million or 62% during the nine months ended September 30, 2008 compared with an increase of \$2.5 million or 10% for the nine months ended September 30, 2007. The increase in 2008 reflects inventory necessary to support growth in our business.

Deferred revenue, which represents deferred service contract revenue that is being amortized over the service contract period, increased by \$18.1 million or 33% for the nine months ended September 30, 2008 compared with an increase of \$11.2 million or 30% during the nine months ended September 30, 2007 which is primarily related to the increase in the number of installed systems for which service contracts exist.

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Other liabilities including accounts payable, accrued compensation and employee benefits, and accrued liabilities increased by \$4.3 million or 4% during the nine months ended September 30, 2008 compared to an increase of \$16.1 million or 36% during the nine months ended September 30, 2007 primarily due to the timing of vendor payments.

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### **Investing Activities**

Net cash used in investing activities during the nine months ended September 30, 2008 and 2007 consisted primarily of purchases of investments (net of proceeds from sales and maturities of investments) of \$93.2 million and \$147.4 million respectively, and, capital expenditures and acquisitions of intellectual property of \$73.0 million and \$12.2 million respectively. Our investments are in U.S. treasuries and government agencies, money market funds, corporate debt, commercial paper, and municipal bonds (which may have an auction reset feature). Capital expenditure of \$73.0 million during the nine months ended September 30, 2008 included \$20.0 million of land and land improvements associated with our plans to construct a 154,000 sq ft manufacturing and engineering facility in Sunnyvale, California, \$33.5 million of acquired intellectual property rights for use in the development of surgical robotic products, which intellectual property rights are being amortized over their expected useful dates of 5 years; and facilities improvements and information technology infrastructure to support capacity expansion in our business. In October 2008, we purchased an approximately 75,000 sq. ft building near our Corporate Headquarters in Sunnyvale, California for \$13.5 million, intended to be used for shipping and logistics.

### **Financing Activities**

Net cash provided by financing activities during the nine months ended September 30, 2008 consisted primarily of proceeds from stock option exercises and employee stock purchases of \$42.0 million and excess tax benefits from stock-based compensation of \$52.8 million. Net cash provided by financing activities during the nine months ended September 30, 2007 consisted primarily of proceeds from stock option and warrant exercises of \$41.6 million and excess tax benefits from stock-based compensation of \$47.1 million.

### **Auction Rate Securities**

At September 30, 2008, we recorded all investments at fair value in accordance with SFAS 157. As defined by SFAS 157, we classified the majority of our investments were classified as either Level 1 or Level 2; however, we classified \$86.6 million of municipal bond investments with an auction reset feature ( auction rate securities or ARS ) as Level 3. The underlying assets of these auction rate securities are student loans which are substantially backed by the federal government.

Auction-rate securities are long-term floating rate bonds tied to short-term interest rates. After the initial issuance of the securities, the interest rate on the securities is reset periodically, at intervals established at the time of issuance (primarily every twenty-eight days), based on market demand for a reset period. Auction-rate securities are bought and sold in the marketplace through a competitive bidding process often referred to as a Dutch auction. If there is insufficient interest in the securities at the time of an auction, the auction may not be completed and the rates may be reset to predetermined penalty or maximum rates based on mathematical formulas in accordance with each security's prospectus.

In February 2008, auctions began to fail for these securities and each auction since then has failed. Consequently, the investments are not currently liquid and we will not be able to access these funds until a future auction of these investments is successful or a buyer is found outside of the auction process. All but one of our ARS are currently rated AAA, the highest rating, by a rating agency. We do not expect to need to access these funds in the short-term; however, in the event we are needed to access these funds, they are not expected to be accessible until one of the following occurs: a successful auction occurs, the issuer redeems the issue, a buyer is found outside of the auction process or the underlying securities mature. In October 2008, we received an Offer from UBS, of our investment advisors, to sell at par value auction-rate securities originally purchased from UBS (approximately \$71 million) at anytime during a two-year period beginning June 30, 2010. The Offer is non-transferable and expires on November 14, 2008. The acceptance of the Offer will likely result in a charge to income for the difference between the fair value of the Offer and the unrealized loss in the auction rate securities held (\$6.0 million at September 30, 2008 related to the auction-rate securities held by UBS). We are in the process of evaluating the Offer and its potential financial statements impact.

Typically, the fair value of ARS investments approximates par value due to the frequent resets through the auction process. While we continue to earn interest on its ARS investments at the contractual rate, these investments are not currently trading and therefore do not have a readily determinable market value. At September 30, 2008, our investment advisors provided a Level 3 valuation for the ARS investments. The investment advisors utilized a discounted cash flow approach to arrive at this valuation, which was corroborated by a separate and comparable discounted cash flow analysis prepared by us. The assumptions used in preparing the discounted cash flow model include estimates of, based on data available as of September 30, 2008, interest rates, timing and amount of cash flows, credit and liquidity premiums, and expected holding periods of the ARS. These assumptions are volatile and subject to change as the underlying sources of these assumptions and market conditions change.

Based on this Level 3 valuation, we recorded an unrealized loss on these investments of \$8.3 million at September 30, 2008, which we believe to be temporary. Although there is uncertainty with regard to the short-term liquidity of these securities, we continue to believe that the carrying value represents the fair value of these marketable securities because of the overall quality of the underlying



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investments and the anticipated future market for such investments. In addition, we have the intent and ability to hold these securities until the earlier of: the market for auction rate securities stabilizes, the issuer refinances the underlying security, a buyer is found outside of the auction process at acceptable terms, the underlying securities have matured or we accept the investment manager's offer to redeem the securities.

Based on the cash, cash equivalents and short-term investments balance of \$408.2 million and expected positive operating cash flows we do not anticipate that the lack of liquidity associated with the auction rate securities will adversely affect our ability to conduct our business, and our ability to hold the securities throughout the currently estimated recovery period. We will continue to evaluate any changes in the market value of the failed auction rate securities that have not been liquidated subsequent to quarter-end. Depending upon future market conditions, we may be required to record an other-than-temporary decline in market value at that time. Furthermore, given the volatility of the Level 3 assumptions used in the discounted cash flow analysis, this potential income statement impact may be greater than the \$8.3 million we estimated above.

## **Liquidity**

At September 30, 2008 we had cash, cash equivalents and investments of \$821.4 million. A portion of these are held as cash in operating accounts that are with third party financial institutions. These balances exceed the Federal Deposit Insurance Corporation (FDIC) insurance limits. While we monitor daily the cash balances in our operating accounts and adjust the cash balances as appropriate, these cash balances could be impacted if the underlying financial institutions fail or be subject to other adverse conditions in the financial markets. To date we have experienced no loss or lack of access to cash in our operating accounts.

The remainder of our cash equivalents and investments are invested in interest bearing funds managed by third party financial institutions. These funds invest in U.S. treasuries and government agencies, money market funds, corporate debt, commercial paper, and municipal bonds (which may have an auction reset feature). Except with respect to the auction rate securities (as further described under Auction Rate Securities above), to date we have experienced no material loss or lack of access to our cash and investments; however, we can provide no assurances that access to our cash and investments will not be impacted by adverse conditions in the financial markets.

## ***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. We discuss our newly adopted Fair Value policy below.

## **Fair Value Measurements**

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 our 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.

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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. treasuries and government agencies, corporate debt, money market funds, commercial paper and municipal bonds (which may have an auction reset feature). 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). The weighted-average maturity of our investments excluding auction rate securities as of September 30, 2008 was approximately one year. 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 \$1.5 million as of September 30, 2008. We do not utilize derivative financial instruments to manage our interest rate risks.

At September 30, 2008, we held approximately \$86.6 million of municipal bond investments, classified as long-term assets, with an auction reset feature ( auction rate securities ) whose underlying assets are 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. Consequently, the investments are not currently liquid and the Company will not be able to access these funds until a future auction of these investments is successful or a buyer is found outside of the auction process. As a result, our ability to liquidate our investment and fully recover the carrying value of our investment in the near term may be limited or not exist. An auction failure means that the parties wishing to sell securities could not. All but one 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 and their credit ratings deteriorate, we may in the future be required to record an impairment charge on these investments. In October 2008, we received an Offer from UBS, one of our investment advisors, to sell at par value auction-rate securities originally purchased from UBS (approximately \$71 million) at anytime during a two-year period beginning June 30, 2010. The Offer is non-transferable and expires on November 14, 2008. The acceptance of the Offer will likely result in a charge to income for the difference between the fair value of the Offer and the unrealized loss in the auction rate securities held (\$6.0 million at September 30, 2008 related to the auction-rate securities held by UBS). We are in the process of evaluating the Offer and its potential financial statements impact. Based on our expected operating cash flows, and our other sources of cash, we do not anticipate the potential lack of liquidity on these investments will affect our ability to execute our current business plan.

#### **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 September 30, 2008, sales denominated in foreign currencies were approximately 8% of total revenue. For the three months ended September 30, 2008, our revenue would have decreased by approximately \$1.9 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 against all currencies with which we have exposure at September 30, 2008 would have resulted in a \$0.6 million decrease in the carrying amounts of those net assets.

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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.

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**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.

**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.

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**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**

Our Risk Factors are discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007. We have updated our risk factors as stated below to address the effect of the current credit crisis on our business and to address the concerns on our investment portfolio in light of current market conditions.

**CURRENT CREDIT AND FINANCIAL MARKET CONDITIONS COULD DELAY, OR PREVENT OUR CUSTOMERS FROM OBTAINING FINANCING TO PURCHASE THE DA VINCI SURGICAL SYSTEM, WHICH WOULD ADVERSELY AFFECT OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

Due to the recent tightening of credit markets and concerns regarding the availability of credit, particularly in the United States, our customers may be delayed in obtaining, or may not be able to obtain, necessary financing for their purchases of the *da Vinci* Surgical System. Delays of this nature would adversely affect our product sales and revenues, and therefore harm our business and results of operations.

**THE INVESTMENT OF OUR SUBSTANTIAL CASH BALANCE AND OUR INVESTMENTS IN MARKETABLE DEBT SECURITIES ARE SUBJECT TO RISKS WHICH MAY CAUSE LOSSES AND AFFECT THE LIQUIDITY OF THESE INVESTMENTS.**

At September 30, 2008, we had \$227.6 million in cash and cash equivalents and \$593.8 million in investments in marketable debt securities. We have historically invested these amounts in U.S. treasuries and government agencies, corporate debt, money market funds, commercial paper and municipal bonds (which may have an auction reset feature) meeting certain criteria. Certain of these investments are subject to general credit, liquidity, market and interest rate risks. While we do not hold any investments whose value is directly correlated to sub-prime debt, these risks have been and may further be exacerbated by U.S. sub-prime mortgage defaults, which have affected various sectors of the financial markets and caused credit and liquidity issues. During the quarter ended September 30, 2008, we determined that any declines in the fair value of our investments were temporary. There may be further declines in the value of these investments, which we may determine to be other-than-temporary. These market risks associated with our investment portfolio may have a negative adverse effect on our results of operations, liquidity and financial condition.

At September 30, 2008, we held approximately \$86.6 million of municipal notes investments, classified as long-term assets, with an auction reset feature ( auction rate securities ) whose underlying assets are 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. Consequently, the investments are not currently liquid and the Company will not be able to access these funds until a future auction of these investments is successful or a buyer is found outside of the auction process. As a result, our ability to liquidate our investment and fully recover the carrying value of our investment in the near term may be limited or may not exist. An auction failure means that the parties wishing to sell securities could not. All but one 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 and their credit ratings deteriorate, we may in the future be required to record an impairment charge on these investments. We believe these securities are not significantly impaired, primarily due to the government guarantee of the underlying securities; however, it could take until the final maturity of the underlying bonds (up to 30 years) to realize our investments' recorded value. In October 2008, the Company received an Offer from UBS, one of its investment providers, to sell at par value auction-rate securities originally purchased from UBS (approximately \$71 million) at anytime during a two-year period beginning June 30, 2010. The Offer is non-transferable and expires on November 14, 2008. The acceptance of the Offer will likely result in a charge to income for the difference between the fair value of the Offer and the unrealized loss on the auction rate

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securities held (\$6.0 million at September 30, 2008 related to the auction-rate securities held by UBS). The Company is in the process of evaluating the Offer and its potential financial statements impact. However, there is no assurance that UBS will have enough financial resources necessary to perform its obligations under the Offer. Based on our expected operating cash flows, and our other sources of cash, we do not anticipate the potential lack of liquidity on these investments will affect our ability to execute our current business plan.

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**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.

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**ITEM 6. EXHIBITS**

| <b>Exhibit<br/>Number</b> | <b>Description</b>                                                                                               |
|---------------------------|------------------------------------------------------------------------------------------------------------------|
| 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 |

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**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: October 17, 2008

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