VARIAN MEDICAL SYSTEMS INC
Form 10-Q
February 05, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended December 29, 2006

or

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

For the transition period from ______ to ______

Commission File Number 1-7598

VARIAN MEDICAL SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**94-2359345**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification Number)**
3100 Hansen Way,	**94304-1030**

Palo Alto, California
(Address of principal executive offices) **(Zip Code)**
(650) 493-4000

(Registrant s telephone number, including area code)

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

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 128,446,602 shares of common stock, par value $1 per share, outstanding as of January 26, 2007.

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FORM 10-Q for the Quarter Ended December 29, 2006

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

	Three Months Ended	
(In thousands, except per share amounts)	**December 29, 2006**	**December 30, 2005**
Revenues:		
Product	$ 317,823	$ 274,973
Service contracts and other	70,035	59,258
Total revenues	387,858	334,231
Cost of revenues:		
Product	190,933	161,745
Service contracts and other	36,775	33,722
Total cost of revenues	227,708	195,467
Gross margin	160,150	138,764
Operating expenses:		
Research and development	26,966	22,217
Selling, general and administrative	63,142	56,783
Total operating expenses	90,108	79,000
Operating earnings	70,042	59,764
Interest income	3,488	2,750
Interest expense	(1,042)	(1,084)
Earnings from operations before taxes	72,488	61,430
Taxes on earnings	22,987	20,270
Net earnings	$ 49,501	$ 41,160
Net earnings per share - Basic	$ 0.38	$ 0.31
Net earnings per share - Diluted	$ 0.37	$ 0.30
Weighted average shares used in the calculation of:		
Net earnings per share - Basic	129,198	131,138
Net earnings per share - Diluted	132,963	135,938

See accompanying notes to the consolidated financial statements.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except par values)	December 29, 2006	September 29, 2006 (1)
Assets		
Current assets:		
Cash and cash equivalents	$ 264,266	$ 272,508
Short-term marketable securities	98,578	93,599
Accounts receivable, net of allowance for doubtful accounts of $4,359 at December 29, 2006 and $4,473 at September 29, 2006	395,835	471,820
Inventories	223,712	189,653
Prepaid expenses and other current assets	32,313	25,953
Deferred tax assets	100,553	102,516
Total current assets	1,115,257	1,156,049
Property, plant and equipment, net	135,774	130,318
Goodwill	121,389	121,389
Other assets	120,236	103,995
Total assets	$ 1,492,656	$ 1,511,751
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 73,425	$ 77,985
Accrued expenses	249,343	265,750
Deferred revenues	112,801	117,813
Current maturities of long-term debt	7,958	7,954
Product warranty	44,837	42,992
Advance payments from customers	133,106	131,462
Total current liabilities	621,470	643,956
Long-term debt	49,303	49,356
Other long-term liabilities	22,717	21,186
Total liabilities	693,490	714,498
Commitments and contingencies (Note 8)		
Stockholders equity:		
Preferred stock of $1 par value: 1,000 shares authorized; none issued and outstanding		
Common stock of $1 par value: 189,000 shares authorized; 128,891 and 129,721 shares issued and outstanding at December 29, 2006 and at September 29, 2006, respectively	128,891	129,721
Capital in excess of par value	280,775	265,214
Retained earnings	394,031	406,849
Accumulated other comprehensive loss	(4,531)	(4,531)

Total stockholders equity	799,166	797,253
Total liabilities and stockholders equity	$ 1,492,656	$ 1,511,751

(1) The condensed consolidated balance sheet as of September 29, 2006 was derived from audited financial statements as of that date, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

See accompanying notes to the consolidated financial statements.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)	Three Months Ended December 29, 2006	Three Months Ended December 30, 2005
Cash flows from operating activities:		
Net earnings	$ 49,501	$ 41,160
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Tax benefits from exercises of share-based payment awards	8,171	24,669
Excess tax benefits from share-based compensation	(7,632)	(21,791)
Share-based compensation expense	10,946	8,156
Depreciation	6,056	5,791
Provision for doubtful accounts receivable	(34)	170
Loss on disposal of property, plant and equipment	41	8
Amortization of intangible assets	1,257	1,466
Amortization of premium/discount on marketable securities, net	21	46
Deferred taxes	(684)	(2,709)
Net change in fair value of derivatives and underlying commitments	(2,240)	3,287
Income on equity investment in affiliate	(17)	(845)
Changes in assets and liabilities:		
Accounts receivable	81,200	3,223
Inventories	(34,041)	(13,632)
Prepaid expenses and other current assets	(1,314)	(1,721)
Accounts payable	(5,418)	(13,513)
Accrued expenses	(21,243)	(22,400)
Deferred revenues	(5,012)	(1,512)
Product warranty	1,746	(1,018)
Advance payments from customers	793	5,470
Other long-term liabilities	691	(426)
Net cash provided by operating activities	82,788	13,879
Cash flows from investing activities:		
Proceeds from maturities or sale of marketable securities	60,000	29,510
Purchases of marketable securities	(65,000)	(20,000)
Purchases of property, plant and equipment	(12,191)	(8,561)
Equity investment in affiliate	(4,543)	
Increase in cash surrender value of life insurance	(3,480)	(709)
Note receivable from affiliate and other	(3,352)	(284)
Proceeds from disposal of property, plant and equipment	638	247
Other, net	33	(2,056)
Net cash used in investing activities	(27,895)	(1,853)
Cash flows from financing activities:		
Repurchases of common stock	(76,645)	(39,282)
Proceeds from issuance of common stock to employees	9,999	29,208
Excess tax benefits from share-based compensation	7,632	21,791
Employees taxes withheld and paid for restricted performance shares and restricted stock	(53)	(8,077)
Repayments of bank borrowings	(49)	(53)

Net cash provided by (used in) financing activities	(59,116)	3,587
Effects of exchange rate changes on cash and cash equivalents	(4,019)	911
Net increase (decrease) in cash and cash equivalents	(8,242)	16,524
Cash and cash equivalents at beginning of period	272,508	243,086
Cash and cash equivalents at end of period	$ 264,266	$ 259,610

See accompanying notes to the consolidated financial statements.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

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

Fiscal Year

The Company s fiscal year is the 52- or 53-week period ending on the Friday nearest September 30. Fiscal year 2007 is the 52-week period ending September 28, 2007, and fiscal year 2006 was the 52-week period ended September 29, 2006. The fiscal quarters ended December 29, 2006 and December 30, 2005 were both 13-week periods.

Basis of Presentation

The condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements and the accompanying notes are unaudited and should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended September 29, 2006. In the opinion of management, the condensed consolidated financial statements herein include adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Company s financial position as of December 29, 2006 and September 29, 2006, results of operations for the three months ended December 29, 2006 and December 30, 2005, and cash flows for the three months ended December 29, 2006 and December 30, 2005. The results of operations for the three months ended December 29, 2006 are not necessarily indicative of the operating results to be expected for the full fiscal year or any future periods.

Use of Estimates

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

Share-Based Compensation Expense

In accordance with Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)), the Company measures and recognizes compensation expense for all share-based payment awards made to employees and directors, including stock options, employee stock purchases related to the Varian Medical Systems, Inc. Employee Stock Purchase Plan (the Employee Stock Purchase Plan), deferred stock units and restricted stock based on their fair values. See Note 11 of the Notes to the Condensed Consolidated Financial Statements for a detailed discussion of SFAS 123(R).

The Company adopted the short-cut method provided in Financial Accounting Standards Board Staff Position No.123(R)-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards,* for calculating the tax effects of share-based compensation pursuant to SFAS 123(R). The short-cut method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of share-based compensation, and to determine the subsequent impact on the APIC pool and the Condensed Consolidated Statements of Cash Flows of the tax effects of share-based compensation awards that are outstanding upon adoption of

SFAS 123(R).

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Recent Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154), a replacement of APB No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 changes the requirements for accounting for and reporting a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition via a cumulative effect adjustment within net income of the period of the change. SFAS 154 requires retrospective application to prior periods financial statements unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The Company adopted SFAS 154 in the first quarter of fiscal year 2007 and there was no impact to its consolidated financial position, results of operations or cash flows.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (SFAS 109). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109. This interpretation will be effective for the Company in the first quarter of fiscal year 2008. The Company is evaluating the impact of the adoption of this interpretation on the Company s consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact that SFAS 157 may have on its consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 158, *Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (SFAS 158). SFAS 158 requires the Company to (a) recognize a plan s funded status in its statement of financial position, (b) measure a plan s assets and its obligations that determine the plan s funded status as of the end of the employer s fiscal year and (c) recognize changes in the funded status of a defined postretirement plan in the year in which the changes occur through other comprehensive income. The requirement to recognize the funded status of a defined benefit plan and the disclosure requirements are effective for the Company s fiscal year ending September 28, 2007. Based on the funded status of the Company s plan obligations disclosed in Note 9 of the Notes to the Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the fiscal year ended September 29, 2006, the estimated impact of adopting SFAS 158 would have been a decrease in total assets at September 29, 2006 of approximately $3 million, an increase in total liabilities of approximately $18 million and a reduction in stockholders equity of approximately $21 million, excluding the impact of taxes. There would have been no impact on the Company s fiscal year 2006 Consolidated Statements of Earnings or Cash Flows. The actual impact of the implementation of SFAS 158 on the fiscal year 2007 financial statements will differ from that estimate due to changes in economic assumptions such as discount rates, measurement of fair values of plan assets, and other changes in actuarial assumptions that will occur in connection with the next measurement date on September 28, 2007.

In September 2006, the SEC issued SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108), to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires the quantification of misstatements based on their impact on both the balance sheet and the income statement to determine materiality. The guidance provides for a one-time cumulative effect adjustment to correct for misstatements that were not deemed material under a company s prior approach but are material under the SAB 108 approach. SAB 108 will be effective for the Company s fourth quarter of fiscal year ending September 28, 2007. The Company is assessing the potential impact that SAB 108 may have on its consolidated financial position, results of operations and cash flows. However, based on the evaluation to date, the Company believes there will be no impact at adoption on its financial statements or related disclosures.

Reclassifications

Certain financial statement items have been reclassified to conform to the current year s format. These reclassifications had no impact on previously reported net earnings.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

2. MARKETABLE SECURITIES

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

(In millions)	December 29, 2006	September 29, 2006
Short-term marketable securities	$ 98.6	$ 93.6
Marketable securities classified as:		
Available-for-sale	$ 95.0	$ 90.0
Held-to-maturity	3.6	3.6
	$ 98.6	$ 93.6

At December 29, 2006, the remaining contractual maturities of all marketable securities were less than one year.

3. INVENTORIES

The components of inventories are as follows:

(In millions)	December 29, 2006	September 29, 2006
Raw materials and parts	$ 124.9	$ 108.5
Work-in-progress	11.3	14.4
Finished goods	87.5	66.8
Total inventories	$ 223.7	$ 189.7

4. GOODWILL AND INTANGIBLE ASSETS

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

The Company performed its annual SFAS 142 goodwill impairment assessment for its two reporting units that have goodwill in the fourth quarter of fiscal year 2006 and determined that there was no impairment. However, the Company could be required to record impairment charges in future periods if indicators of potential impairment exist.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

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

(In millions)	December 29, 2006	September 29, 2006
Intangible Assets:		
Acquired existing technology	$ 14.1	$ 14.1
Patents, licenses and other	13.9	13.9
Customer contracts and supplier relationships	10.1	10.1
Accumulated amortization	(25.5)	(24.3)
Net carrying amount	$ 12.6	$ 13.8

Amortization expense for intangible assets required to be amortized under SFAS 142 was $1.3 million for the three months ended December 29, 2006 and $1.5 million for the three months ended December 30, 2005. At December 29, 2006, the Company estimates amortization expense on a straight-line basis for the remaining nine months of fiscal year 2007, fiscal years 2008 through 2011, and thereafter, to be as follows (in millions): $3.2, $3.1, $2.4, $2.0, $1.3 and $0.6.

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

(In millions)	December 29, 2006	September 29, 2006
Oncology Systems	$ 120.9	$ 120.9
X-ray Products	0.5	0.5
Total	$ 121.4	$ 121.4

5. RELATED PARTY TRANSACTIONS

In fiscal years 1999 and 2000, VMS invested a total of $5 million in a three member consortium for a 20% ownership interest in dpiX Holding LLC (dpiX Holding), which in turn invested $25 million for an 80.1% ownership interest in dpiX LLC (dpiX), a supplier of amorphous silicon based thin-film transistor arrays (flat panels) for the Company s X-ray Products digital imaging subsystems and for its Oncology Systems On-Board Imager and PortalVision imaging systems. During the three months ended December 29, 2006 and December 30, 2005, the Company purchased flat panels from dpiX totaling approximately $6.5 million and $4.5 million, respectively, which are included as a component of Inventory in the Condensed Consolidated Balance Sheets and Cost of revenues - product in the Condensed Consolidated Statements of Earnings for these periods. VMS had the right to appoint one manager of the five person board of managers and the investment was accounted for under the equity method. In accordance with the dpiX Holding agreement, net losses were to be allocated to the other two members, in succession, until their capital accounts equaled zero, before being allocated to VMS. The dpiX Holding agreement also provided that net profits were to be allocated to the other two members, in succession, until their capital accounts equaled the net losses previously allocated, then to the three members in accordance with their ownership interests.

In September 2004, VMS acquired another member s entire 20% ownership interest in dpiX Holding for $1 million. As a result, VMS has the right to appoint two managers of the five person board of managers and its ownership interest in dpiX Holding increased to 40% with the remaining 60% being held by the other original member. When VMS acquired this additional 20% ownership interest, the capital account of the selling member was nearly zero because it was the first in the consortium to be allocated losses. However, dpiX Holding has been profitable since VMS acquired the additional 20% ownership interest. As a result, VMS was the first to be allocated net profits to recover previously allocated losses and recorded in the three months ended December 29, 2006 and December 30, 2005 income on the equity investment in dpiX Holding of $17,000 and $845,000, respectively, which is included in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

In accordance with the dpiX agreement, the member that owns the other 19.9% ownership interest in dpiX had the right to sell back to dpiX on dpiX s last business day in December 2004, 2005 and 2006, cumulatively all of that member s ownership interest for $5 million if dpiX had not become a publicly traded company as of the last business day in December 2004. In December 2004, that member exercised its right to sell back to dpiX its 19.9% ownership interest. On each of December 22, 2005 and December 24, 2004, dpiX repurchased from that member a 7.96% ownership interest for a payment of $2 million (in aggregate, a 15.92% interest for $4 million). On December 22, 2006, dpiX repurchased the remaining 3.98% ownership interest for $1 million. As a result, VMS s indirect ownership interest in dpiX increased to 40% as of December 29, 2006.

In December 2004, VMS agreed to loan $2 million to dpiX in four separate installments, bearing interest at prime rate plus 1% per annum. The principal balance is due and payable to VMS in twelve equal quarterly installments that began in October 2006; interest is payable in full according to the same quarterly schedule, but began in April 2005; and the entire principal balance, together with accrued and unpaid interest thereon and all other related amounts payable hereunder, is fully due and payable on July 10, 2009. The note receivable from dpiX totaled $1.8 million and $2 million at December 29, 2006 and September 29, 2006, respectively, and is primarily included in Other Assets in the Condensed Consolidated Balance Sheet.

In March 2006, VMS and the other member of dpiX Holding agreed in principle to invest an aggregate of $92 million in dpiX Holding for dpiX to acquire and construct a manufacturing facility in Colorado to increase its production capacity. The members contributions for this facility are based on their percentage of ownership interest in dpiX Holding. As of December 29, 2006, VMS had contributed to dpiX Holding approximately $16.8 million, which is included in Other assets. VMS expects to invest an additional $20 million in dpiX Holding over the next eight months.

6. PRODUCT WARRANTY

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

The following table reflects the change in the Company s accrued product warranty during the three months ended December 29, 2006 and December 30, 2005:

	Three Months Ended	
(In millions)	**December 29, 2006**	**December 30, 2005**
Accrued product warranty, at beginning of period	$ 43.0	$ 39.4
Charged to cost of revenues	10.0	8.2
Actual product warranty expenditures	(8.2)	(9.2)
Accrued product warranty, at end of period	$ 44.8	$ 38.4

7. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company has significant transactions denominated in foreign currencies and addresses certain financial exposures through a program of risk management that includes the use of derivative financial instruments. The Company sells products throughout the world, often in the currency of the customer s country, and typically hedges many of these firmly committed foreign currency sales orders. These firmly committed foreign currency sales orders are hedged using forward exchange contracts. The Company enters into foreign currency forward exchange contracts primarily to reduce the effects of fluctuating foreign currency exchange rates. The Company does not enter into forward exchange contracts for speculative or trading purposes. The forward exchange contracts range from one to twelve months in original maturity. As of December 29, 2006, the Company did not have any forward exchange contracts with an original maturity greater than twelve months. As international deliveries may extend beyond twelve months, the Company may hedge beyond twelve months in the future.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

The Company accounts for its hedges of foreign currency denominated sales orders (firm commitments) as fair value hedges as prescribed by SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 149, *Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities* (SFAS 133). For the three months ended December 29, 2006, there were no material gains or losses due to hedge ineffectiveness. At December 29, 2006, the Company had foreign exchange forward contracts for fair value hedges with notional values to sell and purchase $347.5 million and $72.7 million, respectively, in various foreign currencies. At December 29, 2006, all open forward exchange contracts were deemed effective.

The Company also hedges balance sheet exposures from its various foreign subsidiaries and business units. The Company enters into monthly foreign currency forward exchange contracts to minimize the short-term impact of foreign currency fluctuations on assets and liabilities denominated in currencies other than the U.S. dollar functional currency. These hedges of foreign-currency-denominated assets and liabilities do not qualify for hedge accounting treatment under SFAS 133. For derivative instruments not designated as hedging instruments, changes in their fair values are recognized in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings.

Changes in the values of these hedging instruments are offset by changes in the values of foreign currency denominated assets and liabilities. Variations from the forecasted foreign currency assets or liabilities, coupled with a significant currency movement, may result in a material gain or loss if the hedges are not effectively offsetting the change in value of the foreign currency asset or liability.

Other than foreign exchange hedging activities, the Company has no other freestanding or embedded derivative instruments.

8. COMMITMENTS AND CONTINGENCIES

Commitments

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

On February 2, 2004, the Company s Japanese subsidiary (VMS KK) purchased the Service Business for 2.0 billion Japanese Yen, or US$19.1 million, plus a contingent earn out payable to MELCO at the end of the three-year JVA period. This earn out payment is equivalent to 100% of the net profits or losses of the Service Business for the three-year period. The Company accounted for the purchase of the Service Business as an acquisition and 100% of the profits and losses from VMS KK are reflected in the Company s consolidated results. The Company accounts for the earn out payment equivalent to 100% of the net profits or losses of the Service Business during the three-year period as an adjustment to the purchase price of the acquisition at the end of the period. For the period from February 2, 2004 to December 29, 2006, net profits for the Service Business totaled approximately $4.1 million. Assuming no future profits or losses, $4.1 million would be payable to MELCO at the end of the three-year JVA period.

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

The JVA was accomplished through MELCO s purchase on February 3, 2004 of a 35% ownership interest in VMS KK for 1.4 billion Japanese Yen, or US$13.5 million. During the three-year JVA period, MELCO was not entitled to any profits or losses generated by VMS KK. However, MELCO was entitled to elect one of the five members of VMS KK s board of directors. At the end of the three-year JVA period, MELCO was required to unconditionally sell and the Company was

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

required to unconditionally repurchase MELCO s 35% ownership interest in VMS KK at the original sale price (1.4 billion Japanese Yen) and there are no settlement alternatives to such a repurchase obligation. The Company has accounted for MELCO s 35% ownership interest as a mandatorily redeemable financial instrument, which is included in Accrued expenses in the Condensed Consolidated Balance Sheets. On February 2, 2007, the Company repurchased the 35% ownership interest in the JVA from MELCO for 1.4 billion Japanese Yen, or US $11.8 million.

Contingencies

The U.S. Environmental Protection Agency (EPA) or third parties have named the Company as a potentially responsible party (PRP) under the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended (CERCLA), at eight sites where the Company, as Varian Associates, Inc., is alleged to have shipped manufacturing waste for recycling or disposal, and as a PRP the Company may have an obligation to reimburse the EPA or other third parties for cleanup costs at these sites. In addition, the Company is overseeing environmental cleanup projects and, as applicable, reimbursing third parties for cleanup activities under the direction of, or in consultation with, federal, state and/or local agencies at certain current VMS or former Varian Associates, Inc. facilities (including facilities disposed of in connection with the Company s sale of its Electron Devices business during 1995 and the sale of its thin film systems business during 1997). Under the terms of the agreement governing the spin-offs of Varian, Inc. (VI) and Varian Semiconductor Equipment Associates, Inc. (VSEA), by the Company in 1999, VI and VSEA are each obligated to indemnify the Company for one-third of these environmental cleanup costs (after adjusting for any insurance proceeds realized or tax benefits recognized by the Company). The Company spent $0.2 million and $0.4 million (net of amounts borne by VI and VSEA) during the three months ended December 29, 2006 and December 30, 2005, respectively, on environmental cleanup costs, third-party claim costs, project management costs and legal costs.

Various uncertainties make it difficult to estimate the likelihood or cost of certain third-party claims, project management costs and legal costs at all of the sites and facilities. In addition, for the eight sites and one of the facilities, various uncertainties make it difficult to assess the likelihood and scope of further cleanup activities or to estimate the future cost of such activities. As of December 29, 2006, the Company nonetheless estimated that the Company s future exposure (net of VI s and VSEA s indemnification obligations) for the cleanup costs, third party-claims, project management costs and legal costs for these nine locations ranged in the aggregate from $3.5 million to $7.2 million. The time frames over which these cleanup project costs are estimated vary ranging from one year up to 14 years as of December 29, 2006. Management believes that no amount in the foregoing range of estimated future costs is more probable of being incurred than any other amount in such range and therefore accrued $3.5 million for these cleanup projects as of December 29, 2006. The amount accrued has not been discounted to present value due to the uncertainties that make it difficult to develop a best estimate of future costs.

As to all other facilities, the Company has gained sufficient knowledge to better estimate the scope and costs of future cleanup activities based upon formal agreements with other parties defining the Company s future liabilities or formal cleanup plans that have either been approved by or completed in accordance with the requirements of the state or federal environmental agency with jurisdiction over the facility. As of December 29, 2006, the Company estimated that the Company s future exposure (net of VI s and VSEA s indemnification obligations) for the cleanup costs at these facilities, and reimbursements of third party s claims for these facilities, ranged in the aggregate from $9.6 million to $36.3 million. The time frames over which these cleanup project costs are estimated vary, ranging from 2 years to 30 years as of December 29, 2006. As to each of these facilities, management determined that a particular amount within the range of estimated costs was a better estimate of the future environmental liability than any other amount within the range, and that the amount and timing of these future costs were reliably determinable. The best estimate within the range was $17.6 million at December 29, 2006. The Company accordingly accrued $11.9 million, which represents its best estimate of the future costs of $17.6 million discounted at 4%, net of inflation. This accrual is in addition to the $3.5 million described in the preceding paragraph.

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

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

The Company evaluates its liability for environmental-related investigation and cleanup costs in light of the liability and financial strength of potentially responsible parties and insurance companies with respect to which the Company believes that it has rights to contribution, indemnity and/or reimbursement (in addition to the obligations of VI and VSEA). Claims for recovery of environmental investigation and cleanup costs already incurred, and to be incurred in the future, have been asserted against various insurance companies and other third parties. The Company receives certain cash payments in the form of settlements and judgments from defendants, its insurers and other third parties from time to time. The Company has also reached an agreement with another insurance company under which the insurance company has agreed to pay a portion of the Company s past and future environmental-related expenditures, and the Company therefore recorded a $2.9 million receivable at December 29, 2006, of which $2.8 million was included in Other assets and $0.1 million was included in Prepaid expenses and other current assets . The Company believes that this receivable is recoverable because it is based on a binding, written settlement agreement with a solvent and financially viable insurance company and the insurance company has in the past paid the claims that the Company has made.

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

9. RETIREMENT PLANS

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

	Three Months Ended	
(In thousands)	**December 29, 2006**	**December 30, 2005**
Defined Benefit Plans		
Service cost	$ 1,185	$ 929
Interest cost	1,043	844
Expected return on plan assets	(1,127)	(841)
Amortization of transition amount		(2)
Amortization of prior service cost	31	32
Recognized actuarial loss	236	213
Net pension benefit cost	$ 1,368	$ 1,175
Post-Retirement Benefit Plans		
Interest cost	94	71
Amortization of transition amount	123	123
Amortization of prior service cost	1	1
Recognized actuarial (gain)/loss	5	(1)
Net pension benefit cost	$ 223	$ 194

The Company made contributions to the defined benefit plans of $0.9 million during the three months ended December 29, 2006. The Company currently expects total contributions to the defined benefit plans for fiscal year 2007 will be approximately $4.7 million. The Company made contributions to the post-retirement benefit plans of $0.1 million during the three months ended December 29, 2006. The Company currently expects total contributions to the post-retirement benefit plans for fiscal year 2007 will be approximately $0.5 million.

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10. STOCKHOLDERS EQUITY

Stock Repurchase Program

On November 20, 2006, the Company announced that its Board of Directors had approved the repurchase of an additional 4,500,000 million shares of VMS common stock over the period through September 28, 2007 in addition to the 1,500,000 shares of common stock that had been available for repurchase as of September 29, 2006 under the prior program. During the three months ended December 29, 2006, the Company paid $76.6 million to repurchase 1,500,000 shares of VMS common stock. All shares that have been repurchased have been retired. As of December 29, 2006, the Company could repurchase up to 4,500,000 shares of VMS common stock under the November 20, 2006 authorization.

Comprehensive Earnings

Comprehensive earnings for the three months ended December 29, 2006 and December 30, 2005 equaled the reported net earnings.

11. EMPLOYEE STOCK PLANS

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

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

In February 2005, VMS s stockholders approved the 2005 Omnibus Stock Plan (the 2005 Plan), which provides for the grant of equity incentive awards, including stock options, restricted stock, stock appreciation rights, performance units, restricted stock units and performance shares of up to (a) four million shares, plus (b) the number of shares authorized for issuance, but never issued, under the Omnibus Plan and the 2000 Plan, plus (c) the number of shares subject to awards previously granted under the Omnibus Plan and 2000 Plan that terminate, expire, or lapse and (d) amounts granted in substitution of options in connection with certain transactions. For purposes of the total number of shares available for grant under the 2005 Plan, any shares that are subject to awards of stock options or stock appreciation rights are counted against the available-for-grant limit as one share for every one share issued, and any shares issued in connection with awards other than stock options and stock appreciation rights are counted against the available-for-grant limit as three shares for every one share issued. All awards may be subject to restrictions on transferability and continued employment as determined by the Compensation and Management Development Committee. As of the stockholders approval, awards could no longer be made under the Omnibus Plan or the 2000 Plan.

In November 2005, VMS s Board of Directors approved changes in the employee service requirement for grants of non-qualified stock options made on or after November 17, 2005 under the 2005 Plan to employees who are eligible for retirement at the time of grant from the Company. Under the new requirements, if an employee retires within one year of the grant date, the number of shares subject to the stock option shall be reduced proportionally by the time during such one-year period that the employee ceased to be an employee of the Company (based upon a 365 day year). The revised number of

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shares subject to the stock option would continue to vest in accordance with the original vesting schedule, and the remaining shares cancelled as of the date of retirement. Under the old requirements, if an employee retired within one year of the grant date, all shares subject to the option grant would continue to vest in accordance with the original vesting schedule.

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

Effective October 1, 2005, the Company adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to the Company s employees and VMS directors including stock options and employee stock purchases under the Employee Stock Purchase Plan, deferred stock units and restricted stock based on fair values. The Company s financial statements for the three months ended December 29, 2006 and December 30, 2005 reflect the impact of SFAS 123(R) using the modified prospective transition method. Share-based compensation expense is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Share-based compensation expense recognized in the Condensed Consolidated Statements of Earnings during the three months ended December 29, 2006 and December 30, 2005 included compensation expense for share-based payment awards granted prior to, but not yet vested as of, September 30, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for the share-based payment awards granted subsequent to September 30, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company elected to attribute the value of share-based compensation to expense using the straight-line method, which was previously used for its pro forma information required under SFAS 123. Total share-based compensation expense, before taxes on earnings, was $10.9 million for the three months ended December 29, 2006 and $8.2 million for the three months ended December 30, 2005.

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

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

	Three Months Ended	
	December 29, 2006	**December 30, 2005**
Employee Stock Option Plans		
Expected term (in years)	4.31	4.18
Risk-free interest rate	4.6%	4.4%
Expected volatility	29.3%	29.3%
Expected dividend		
Weighted average fair value at grant date	$ 16.02	$ 15.32
Employee Stock Purchase Plan		
Expected term (in years)	0.50	0.50
Risk-free interest rate	5.0%	4.2%
Expected volatility	22.3%	25.1%
Expected dividend		
Weighted average fair value at grant date	$ 11.18	$ 8.99

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

As share-based compensation expense recognized in the Condensed Consolidated Statements of Earnings for the three months ended December 29, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.

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The table below summarizes the effect of recording share-based compensation expense under SFAS 123(R), which is allocated as follows:

	Three Months Ended	
(In thousands, except per share amounts)	**December 29, 2006**	**December 30, 2005**
Cost of revenues - Product	$ 1,146	$ 420
Cost of revenues - Service contracts and other	866	617
Research and development	1,348	943
Selling, general and administrative	7,586	6,176
Taxes on earnings	(3,744)	(2,699)
Net decrease in net earnings	$ 7,202	$ 5,457
Increase (decrease) on:		
Cash flows from operating activities	$ (7,632)	$ (21,791)
Cash flows from financing activities	$ 7,632	$ 21,791
Decrease on:		
Net earnings per share - Basic	$ 0.06	$ 0.04
Net earnings per share - Diluted	$ 0.05	$ 0.04

During the three months ended December 29, 2006, total share-based compensation expense recognized in earnings before taxes was $10.9 million and the total related recognized tax benefit was $3.7 million. During the three months ended December 30, 2005, total share-based compensation expense recognized in earnings before taxes was $8.2 million and the total related recognized tax benefit was $2.7 million. Total share-based compensation expense capitalized as part of inventory was $0.6 million for the three months ended December 29, 2006 and $0.5 million for the three months ended December 30, 2005.

Activity under the Omnibus Plan, the 2000 Plan, the 2005 Plan and the Amended 2005 Plan (together, the Employee Stock Plans) is presented below:

		Options Outstanding	
(In thousands, except per share amounts)	**Shares Available for Grant**	**Number of Shares**	**Weighted Average Exercise Price**
Balance at September 29, 2006	3,816	15,111	$ 28.90
Granted (1)	(2,620)	2,456	50.66
Cancelled or expired (2)	41	(38)	43.05
Exercised		(616)	16.23
Balance at December 29, 2006	1,237	16,913	$ 32.49

(1) During the three months ended December 29, 2006, VMS granted to certain employees an aggregate of 54,805 shares of restricted common stock under the Amended 2005 Plan.

(2) During the three months ended December 29, 2006, VMS cancelled 1,043 shares of restricted common stock that were tendered to VMS for employees taxes withheld for vested restricted common stock.

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During the three months ended December 29, 2006, the total pre-tax intrinsic value of options exercised was $22 million. The following table summarizes information related to options outstanding and exercisable under the Employee Stock Plans at December 29, 2006:

	Options Outstanding				Options Exercisable			
Range of Exercise Prices (Shares in thousands)	Number of Shares	Weighted Average Remaining Contractual Term (in years)	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)	Number of Shares	Weighted Average Remaining Contractual Term (in years)	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)
$3.88 $13.89	831	2.2	$ 5.16	$ 35,236	831	2.2	$ 5.16	$ 35,236
$13.95 $14.72	2,434	3.8	13.95	81,821	2,434	3.8	13.95	81,821
$14.73 $21.27	1,737	4.7	17.91	51,530	1,737	4.7	17.91	