

MEDTRONIC INC  
Form 10-Q  
September 06, 2006

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

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**FORM 10-Q**

**x QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended July 28, 2006**

**Commission File Number 1-7707**

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**MEDTRONIC, INC.**

(Exact name of registrant as specified in its charter)

**Minnesota**  
(State of incorporation)

**41-0793183**  
(I.R.S. Employer  
Identification No.)

**710 Medtronic Parkway**  
**Minneapolis, Minnesota 55432**  
(Address of principal executive offices)

Telephone number: **(763) 514-4000**

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Shares of common stock, \$.10 par value, outstanding on August 31, 2006: 1,149,343,210

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MEDTRONIC, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS  
(Unaudited)

	<b>Three months ended</b>	
	<b>July 28, 2006</b>	<b>July 29, 2005</b>
(in millions, except per share data)		
Net sales	\$ 2,897	\$ 2,690
Costs and expenses:		
Cost of products sold	732	654
Research and development expense	299	263
Selling, general and administrative expense	984	882
Certain litigation charges	40	
Purchased in-process research and development		364
Other expense, net	66	51
Interest income, net	(39)	(16)
Total costs and expenses	2,082	2,198
Earnings before income taxes	815	492
Provision for income taxes	216	171
Net earnings	\$ 599	\$ 321

Earnings per share:		
Basic	\$ 0.52	\$ 0.26
Diluted	\$ 0.51	\$ 0.26
Weighted average shares outstanding:		
Basic	1,153.8	1,210.5
Diluted	1,164.8	1,222.6

See accompanying notes to the condensed consolidated financial statements.

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MEDTRONIC, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(Unaudited)

	July 28, 2006	April 28, 2006
(dollars in millions, except per share data)		
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,396	\$ 2,994
Short-term investments	4,549	3,107
Accounts receivable, less allowances of \$193 and \$184, respectively	2,444	2,429
Inventories	1,280	1,177
Deferred tax assets, net	226	197
Prepaid expenses and other current assets	536	473
Total current assets	10,431	10,377
Property, plant and equipment	3,921	3,794
Accumulated depreciation	(2,017)	(1,913)
Net property, plant and equipment	1,904	1,881
Goodwill	4,361	4,346
Other intangible assets, net	1,559	1,592
Long-term investments	1,394	957
Long-term deferred tax assets, net	25	
Other long-term assets	507	512
Total assets	\$ 20,181	\$ 19,665

**LIABILITIES AND SHAREHOLDERS' EQUITY**

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Current liabilities:			
Short-term borrowings	\$	2,427	\$ 2,437
Accounts payable		341	319
Accrued compensation		513	723
Accrued income taxes		590	461
Other accrued expenses		568	466
		<hr/>	<hr/>
Total current liabilities		4,439	4,406
Long-term debt		5,485	5,486
Long-term deferred tax liabilities, net			22
Long-term accrued compensation		199	189
Other long-term liabilities		162	179
		<hr/>	<hr/>
Total liabilities		10,285	10,282
Commitments and contingencies (Note 14)			
Shareholders' equity:			
Preferred stock - par value \$1.00			
Common stock - par value \$0.10		115	116
Retained earnings		9,600	9,112
Accumulated other non-owner changes in equity		181	155
		<hr/>	<hr/>
Total shareholders' equity		9,896	9,383
		<hr/>	<hr/>
Total liabilities and shareholders' equity	\$	20,181	\$ 19,665
		<hr/>	<hr/>

See accompanying notes to the condensed consolidated financial statements.

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MEDTRONIC, INC.  
CONDENSED STATEMENTS OF CONSOLIDATED CASH FLOWS  
(Unaudited)

	Three months ended	
	July 28, 2006	July 29, 2005
	<hr/>	<hr/>
	(dollars in millions)	
<b>OPERATING ACTIVITIES:</b>		
Net earnings	\$ 599	\$ 321
Adjustments to reconcile net earnings to net cash provided by (used in) operating activities:		
Depreciation and amortization	140	128
Purchased in-process research and development		364
Provision for doubtful accounts	10	6
Deferred income taxes	(75)	167
Stock-based compensation	49	5
Excess tax benefit from exercise of stock-based awards	(7)	
Change in operating assets and liabilities:		
Accounts receivable	(25)	(28)

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Inventories	(103)	(115)
Accounts payable and accrued liabilities	25	(722)
Changes in other operating assets and liabilities	(33)	(138)
	<u>          </u>	<u>          </u>
Net cash provided by (used in) operating activities	580	(12)
<b>INVESTING ACTIVITIES:</b>		
Acquisitions, net of cash acquired	(6)	(227)
Purchases of intellectual property	(8)	(793)
Additions to property, plant and equipment	(117)	(103)
Purchases of marketable securities	(4,197)	(601)
Sales and maturities of marketable securities	2,315	237
Other investing activities, net	(7)	9
	<u>          </u>	<u>          </u>
Net cash (used in) investing activities	(2,020)	(1,478)
<b>FINANCING ACTIVITIES:</b>		
(Decrease) increase in short-term borrowings, net	(10)	982
Decrease in long-term debt, net	(2)	
Dividends to shareholders	(127)	(117)
Issuance of common stock	58	123
Excess tax benefit from exercise of stock-based awards	7	
Repurchase of common stock	(99)	(229)
	<u>          </u>	<u>          </u>
Net cash (used in) provided by financing activities	(173)	759
Effect of exchange rate changes on cash and cash equivalents	15	89
	<u>          </u>	<u>          </u>
Net change in cash and cash equivalents	(1,598)	(642)
Cash and cash equivalents at beginning of period	2,994	2,232
	<u>          </u>	<u>          </u>
Cash and cash equivalents at end of period	\$ 1,396	\$ 1,590
	<u>          </u>	<u>          </u>

**Supplemental Cash Flow Information**

Cash paid for:		
Income taxes	\$ 162	\$ 59
Interest	22	15
Supplemental Noncash Investing Activities		
Deferred payments for purchases of intellectual property	\$	\$ 30

*See accompanying notes to the condensed consolidated financial statements.*

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financial position, and cash flows in conformity with accounting principles generally accepted in the U.S. In the opinion of management, the condensed consolidated financial statements reflect all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the results of Medtronic, Inc. and its subsidiaries (Medtronic or the Company) for the periods presented. Operating results for interim periods are not necessarily indicative of results that may be expected for the fiscal year as a whole. The preparation of the financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and the related disclosures at the date of the financial statements and during the reporting period. Actual results could materially differ from these estimates. For further information, refer to the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended April 28, 2006.

### Note 2 Stock-Based Compensation

Effective April 29, 2006, the Company adopted the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)) which replaced SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB Opinion No. 25). Under the fair value recognition provisions of SFAS No. 123(R), the Company measures stock-based compensation cost at the grant date based on the fair value of the award and recognizes the compensation expense over the requisite service period, which is generally the vesting period. The Company elected the modified-prospective method of adopting SFAS No. 123(R), under which prior periods are not retroactively restated. The provisions of SFAS No. 123(R) apply to awards granted after the April 29, 2006 effective date. Stock-based compensation expense for non-vested awards granted prior to the effective date is being recognized over the remaining service period using the fair-value based compensation cost estimated for SFAS No. 123 pro forma disclosures. Total stock-based compensation expense included in our statement of earnings for the three months ended July 28, 2006 was \$49 million (\$33 million net of tax).

### **Stock Options**

Stock options awards are granted at exercise prices equal to the closing price of the Company's common stock on the grant date. The majority of the Company's stock option awards are non-qualified stock options with a ten-year life and a four-year ratable vesting term. The Company currently grants stock options under the Medtronic, Inc. 2003 Long-Term Incentive Plan (2003 Plan) and the Medtronic, Inc. 1998 Outside Directors Stock Compensation Plan (Directors Plan). As of July 28, 2006 there were approximately 34 million and 2 million shares available for future grants under each of these plans, respectively.

### **Restricted Stock Awards**

Restricted stock and restricted stock units, collectively restricted stock awards, are granted to officers and key employees. Restricted stock awards are subject to forfeiture if employment terminates prior to the release of the restrictions. The Company grants restricted stock awards that typically cliff vest between three- and five-year periods. Restricted stock is considered issued and outstanding shares of the Company at the grant date and has the same dividend and voting rights as other common stock. Restricted stock units are not considered issued or outstanding common stock of the Company. Dividend equivalent units are accumulated on restricted stock units during the vesting period. The Company grants restricted stock awards under the 2003 Plan and the Directors Plan.

### **Employee Stock Purchase Plan**

The Medtronic, Inc. 2005 Employee Stock Purchase Plan (ESPP) allows participating employees to purchase shares of the Company's common stock at a discount through payroll deductions. Employees can contribute up to the lesser of 10% of their wages or the statutory limit under the U.S. Internal Revenue Code toward the purchase of the Company's common stock at 85% of the market value at the end of the calendar quarter purchase period. Employees purchased 1 million shares at an average price of \$39.88 per share in the first quarter of fiscal year 2007. As of July 28, 2006, plan participants have had approximately \$7 million withheld to purchase Company common stock at 85% of the market value on September 29, 2006, the last day of the calendar quarter purchase period. At July 28, 2006, approximately 8 million shares of common stock were available for future purchase under the ESPP.

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### **Valuation Assumptions**

The Company uses the Black-Scholes option pricing model (Black-Scholes model) to determine the fair value of stock options as of the grant date. The fair value of stock options under the Black-Scholes model requires management to make assumptions regarding projected employee

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stock option exercise behaviors, risk-free interest rates, volatility of the Company's stock price and expected dividends.

The expense recognized for shares purchased under our ESPP is equal to the 15% discount the employee receives at the end of the calendar quarter purchase period. The fair value of restricted stock awards is based on the Company's closing stock price on the date of grant.

The following table provides the weighted average fair value of options granted to employees and the related assumptions used in the Black-Scholes model:

	Three months ended July 28, 2006	Three months ended July 29, 2005
Weighted average fair value of options granted	\$ 14.04	\$ 13.87
<b>Assumptions used:</b>		
Expected life (years) <sup>(a)</sup>	4.63	4.64
Risk-free interest rate <sup>(b)</sup>	4.91%	3.86%
Volatility <sup>(c)</sup>	25.0%	25.0%
Dividend yield <sup>(d)</sup>	0.77%	0.73%

<sup>(a)</sup> *Expected life:* The Company analyzes historical employee exercise and termination data to estimate the expected life assumption. The Company believes that historical data currently represents the best estimate of the expected life of a new employee option. The Company examined its historical pattern of option exercises and determined that management held their stock options for a longer period of time before exercising compared to the rest of the employee population. Therefore the Company stratifies its employee population based upon these distinctive exercise behavior patterns. Prior to adopting SFAS No. 123(R), the Company used the entire employee population for estimating the expected life assumptions.

<sup>(b)</sup> *Risk-free interest rate:* The rate is based on the U.S. Treasury zero-coupon yield curve on the grant date for a maturity similar to the expected life of the options.

<sup>(c)</sup> *Volatility:* The expected volatility of the Company's common stock is calculated by using the historical daily volatility of the Company's stock price calculated over a period of time representative of the expected life of the options.

<sup>(d)</sup> *Dividend yield:* The dividend yield rate is calculated by dividing the Company's annual dividend, based on the most recent quarterly dividend rate, by the closing stock price on the grant date.

### Stock-Based Compensation Expense

Prior to adopting SFAS No. 123(R), the Company accounted for stock options under APB Opinion No. 25 using the intrinsic value method and the impact based on the fair value method on the Company's net earnings was disclosed on a pro forma basis in the footnotes to the consolidated financial statements. In these pro forma disclosures, the Company recognized stock option compensation expense based on the stated vesting period, rather than the time to achieve retirement eligibility. Upon adopting SFAS No. 123(R), the Company changed its method of recognition and now recognizes stock option compensation expense based on the substantive vesting period for all new awards. Compensation expense related to stock options granted prior to fiscal year 2007 that are subject to accelerated vesting upon retirement eligibility is being recognized over the stated vesting term of the grant. If the Company had historically accounted for stock-based awards made to retirement eligible individuals under the requirements of SFAS No. 123(R), the pro forma expense disclosed below would have been decreased by \$4 million for the three months ended July 29, 2005. There was no stock-based compensation expense capitalized as it was deemed immaterial.

The amount of stock-based compensation expense recognized during a period is based on the portion of the awards that are ultimately expected to vest. The Company estimates pre-vesting forfeitures at the time of grant by analyzing historical data and revises those estimates in subsequent periods if actual forfeitures differ from those estimates. Ultimately, the total expense recognized over the vesting period will equal the awards that actually vest.

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The following table presents the statement of earnings classification of pre-tax stock-based compensation expense, for options and restricted stock awards, recognized for the three months ended July 28, 2006:

(dollars in millions)	<b>Three months ended July 28, 2006</b>
Cost of sales	\$ 6
Research and development expense	11
Selling, general and administrative expense	32
	<u>\$ 49</u>

The following table illustrates the effect on net earnings and net earnings per share for the three months ended July 29, 2005 if the Company had applied the fair value recognition provisions of SFAS No. 123 to its stock-based employee compensation:

(dollars in millions, except per share amounts)	<b>Three months ended July 29, 2005</b>
Net earnings, as reported	\$ 321
Add: Stock-based compensation expense included in net earnings <sup>(1)</sup>	3
Less: Stock-based compensation expense determined under fair value based method for all awards <sup>(1)</sup>	(35)
	<u>Pro forma net earnings</u>
	<u>\$ 288</u>
Basic earnings per share:	
As reported	\$ 0.26
Pro forma	\$ 0.24
Diluted earnings per share:	