

MASIMO CORP  
Form 10-Q  
November 01, 2011  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended October 1, 2011

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 001-33642

**Masimo Corporation**

(Exact Name of Registrant as Specified in its Charter)

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**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**33-0368882**  
(I.R.S. Employer  
Identification Number)

**40 Parker**

**Irvine, California**  
(Address of Principal Executive Offices)

**92618**  
(Zip Code)

**(949) 297-7000**  
(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  No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Class	Number of Shares Outstanding as of October 1, 2011
Common stock, \$0.001 par value	60,003,291

**Table of Contents**

**MASIMO CORPORATION**

**FORM 10-Q FOR THE QUARTER ENDED OCTOBER 1, 2011**

**TABLE OF CONTENTS**

**PART I. Financial Information**

Item 1.	<u>Financial Statements (unaudited):</u>	
	<u>Condensed Consolidated Balance Sheets as of October 1, 2011 and January 1, 2011</u>	3
	<u>Condensed Consolidated Statements of Income for the three and nine months ended October 1, 2011 and October 2, 2010</u>	4
	<u>Condensed Consolidated Statements of Cash Flows for the nine months ended October 1, 2011 and October 2, 2010</u>	5
	<u>Notes to Condensed Consolidated Financial Statements</u>	6
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	28
Item 4.	<u>Controls and Procedures</u>	29

**PART II. Other Information**

Item 1.	<u>Legal Proceedings</u>	30
Item 1A.	<u>Risk Factors</u>	30
Item 6.	<u>Exhibits</u>	49
	<b><u>Signatures</u></b>	50

**Table of Contents****PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements****MASIMO CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(unaudited, in thousands, except share amounts)**

	<b>October 1, 2011</b>	<b>January 1, 2011</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 143,192	\$ 88,305
Accounts receivable, net of allowance for doubtful accounts of \$1,684 and \$1,720 at October 1, 2011 and January 1, 2011, respectively	53,526	49,694
Royalties receivable	6,736	12,000
Inventories	45,523	45,028
Prepaid expenses	13,362	7,887
Deferred tax assets	12,588	12,555
Other current assets	1,703	2,136
Total current assets	276,630	217,605
Deferred cost of goods sold	51,508	47,184
Property and equipment, net	15,096	15,951
Intangible assets, net	10,992	10,497
Deferred tax assets	12,542	12,560
Other assets	7,336	6,438
Total assets	\$ 374,104	\$ 310,235
<b>LIABILITIES AND EQUITY</b>		
Current liabilities		
Accounts payable	\$ 20,006	\$ 22,150
Accrued compensation	18,421	21,074
Accrued liabilities	10,764	9,832
Income taxes payable	1,923	722
Deferred revenue	14,876	16,369
Current portion of capital lease obligations	48	50
Total current liabilities	66,038	70,197
Deferred revenue	1,120	1,554
Capital lease obligations, less current portion	87	122
Other liabilities	9,488	8,323
Total liabilities	76,733	80,196
Commitments and contingencies		
Equity		
Masimo Corporation stockholders' equity:		
Preferred stock, \$0.001 par value; 5,000,000 shares authorized; 0 shares issued and outstanding at October 1, 2011 and January 1, 2011	60	59

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Common stock, \$0.001 par value; 100,000,000 shares authorized; 60,003,291 and 59,462,969 shares outstanding at October 1, 2011 and January 1, 2011, respectively

Treasury stock, 156,240 shares at October 1, 2011 and January 1, 2011	(1,209)	(1,209)
Additional paid-in capital	239,218	222,206
Accumulated other comprehensive income	1,294	925
Retained earnings	55,544	5,664
<b>Total Masimo Corporation stockholders' equity</b>	<b>294,907</b>	<b>227,645</b>
Noncontrolling interest	2,464	2,394
<b>Total equity</b>	<b>297,371</b>	<b>230,039</b>
<b>Total liabilities and equity</b>	<b>\$ 374,104</b>	<b>\$ 310,235</b>

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****MASIMO CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(unaudited, in thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	October 1, 2011	October 2, 2010	October 1, 2011	October 2, 2010
Revenue:				
Product	\$ 97,639	\$ 88,823	\$ 301,771	\$ 262,647
Royalty	6,401	12,165	24,876	37,186
Total revenue	104,040	100,988	326,647	299,833
Cost of goods sold	35,601	29,376	106,125	88,379
Gross profit	68,439	71,612	220,522	211,454
Operating expenses:				
Selling, general and administrative	40,134	39,547	125,275	129,862
Research and development	9,372	9,227	28,793	27,688
Antitrust litigation proceeds				(30,728)
Total operating expenses	49,506	48,774	154,068	126,822
Operating income	18,933	22,838	66,454	84,632
Non-operating income (expense)	(240)	1,232	482	1,194
Income before provision for income taxes	18,693	24,070	66,936	85,826
Provision for income taxes	3,869	7,376	17,049	29,052
Net income including noncontrolling interests	14,824	16,694	49,887	56,774
Net (income) loss attributable to the noncontrolling interests	5	(275)	(7)	642
Net income attributable to Masimo Corporation	\$ 14,829	\$ 16,419	\$ 49,880	\$ 57,416
Net income per share attributable to Masimo Corporation stockholders:				
Basic	\$ 0.25	\$ 0.28	\$ 0.83	\$ 0.98
Diluted	\$ 0.24	\$ 0.27	\$ 0.82	\$ 0.95
Weighted average shares used in per share calculations:				
Basic	59,971	58,866	59,804	58,644
Diluted	61,086	60,572	61,082	60,527
Cash dividend declared per share	\$	\$	\$	\$ 2.00

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****MASIMO CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited, in thousands)**

	<b>Nine Months Ended</b>	
	<b>October 1, 2011</b>	<b>October 2, 2010</b>
<b>Cash flows from operating activities:</b>		
Net income including noncontrolling interests	\$ 49,887	\$ 56,774
Adjustments to reconcile net income including noncontrolling interests to net cash provided by operating activities:		
Depreciation and amortization	5,608	4,755
Share-based compensation	10,167	8,887
Provision for doubtful accounts	184	129
Provision for obsolete inventory	1,879	448
Provision for warranty costs	1,919	1,790
Provision for deferred income taxes		133
Income tax benefit from exercise of stock options granted prior to January 1, 2006	1,290	2,072
Excess tax benefit from share-based payment arrangements	(58)	(494)
Changes in operating assets and liabilities:		
Increase in accounts receivable	(4,016)	(10,561)
Decrease in royalties receivable	5,264	
Increase in inventories	(2,374)	(12,290)
Increase in deferred cost of goods sold	(4,321)	(7,201)
(Increase) decrease in prepaid expenses	(5,459)	522
Increase in other assets	(436)	(2,675)
Increase (decrease) in accounts payable	(2,146)	7,189
Increase (decrease) in accrued compensation	(2,744)	1,650
Decrease in accrued liabilities	(1,001)	(734)
Increase in income taxes payable	1,249	1,036
Increase (decrease) in deferred revenue	(1,927)	1,691
Increase in other liabilities	1,101	677
<b>Net cash provided by operating activities</b>	<b>54,066</b>	<b>53,798</b>
<b>Cash flows from investing activities:</b>		
Purchase of short-term investments		(75,986)
Proceeds from sale and maturities of short-term investments		132,975
Purchases of property and equipment	(3,508)	(5,942)
Increase in intangible assets	(1,719)	(1,381)
<b>Net cash provided by (used in) investing activities</b>	<b>(5,227)</b>	<b>49,666</b>
<b>Cash flows from financing activities:</b>		
Repayments of capital lease obligations	(37)	(43)
Proceeds from issuance of common stock	5,568	6,277
Excess tax benefit from share-based payment arrangements	58	494
Dividends paid		(117,506)
<b>Net cash provided by (used in) financing activities</b>	<b>5,589</b>	<b>(110,778)</b>
Effect of foreign currency exchange rates on cash	459	667
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>54,887</b>	<b>(6,647)</b>

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Cash and cash equivalents at beginning of period	88,305	132,054
Cash and cash equivalents at end of period	\$ 143,192	\$ 125,407

The accompanying notes are an integral part of these condensed consolidated financial statements.



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**Table of Contents**

**MASIMO CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1. Description of the Company**

Masimo Corporation, or the Company, is a global medical technology company that develops, manufactures and markets noninvasive patient monitoring products that help clinicians improve patient care. The Company invented Masimo Signal Extraction Technology, or Masimo SET, which provides the capabilities of Measure-Through Motion and Low Perfusion pulse oximetry to address the primary limitations of conventional pulse oximetry. The Company has also developed Masimo rainbow® SET products which monitor multiple blood measurements, including carboxyhemoglobin, methemoglobin, Pleth Variability Index, total hemoglobin, acoustic respiration rate and Halo Index. The Company develops, manufactures and markets a family of patient monitoring solutions which incorporate a monitor or circuit board and sensors, including both proprietary single-patient use and reusable sensors and cables. The Company considers the pulse oximetry device (monitor or circuit board), its sensors and cables and software fees to be products as defined in its condensed consolidated statements of income. The Company sells to hospitals and the alternate care market through its direct sales force and distributors, and markets its circuit boards containing the Company's proprietary algorithm and software architecture to original equipment manufacturer, or OEM, partners.

**2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, have been condensed or omitted pursuant to such rules and regulations. The condensed consolidated financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to present fairly the Company's condensed consolidated financial statements. The condensed consolidated balance sheet as of January 1, 2011 was derived from the Company's audited consolidated financial statements at that date. The accompanying condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company's Annual Report on Form 10-K, filed with the SEC on February 16, 2011. The results for the three and nine months ended October 1, 2011 are not necessarily indicative of the results to be expected for the year ending December 31, 2011 or for any other interim period or for any future year. Certain amounts in the condensed consolidated financial statements for prior periods have been reclassified to conform with current period presentations.

***Principles of Consolidation***

The condensed consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries and the variable interest entities, or VIEs, of which the Company is the primary beneficiary. All intercompany accounts and transactions have been eliminated in consolidation. In accordance with GAAP, current authoritative guidance is applied when determining whether an entity is subject to consolidation.

***Fiscal Periods***

The Company follows a conventional 52/53 week fiscal year. Under a conventional 52/53 week fiscal year, a 52 week year includes four quarters of 13 fiscal weeks while a 53 week fiscal year includes three 13 fiscal week quarters and one 14 fiscal week quarter. In fiscal 2010, the Company followed a 52 week fiscal calendar in which the Company's first, second and third quarters ended on Saturday, April 3, July 3 and October 2, 2010, respectively, and its fiscal year ended on Saturday, January 1, 2011. Similar to fiscal 2010, fiscal 2011 is on a 52 week fiscal calendar in which the Company's first, second and third quarters ended on Saturday April 2, 2011, July 2, 2011 and October 1, 2011, respectively, and its fiscal year will end on Saturday, December 31, 2011.

***Use of Estimates***

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The Company prepares its financial statements in conformity with GAAP, which requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant estimates include: determination of accounts receivable allowances, inventory reserves, warranty reserves, rebate reserves, valuation of the Company's stock options, distributor channel inventory, royalty revenues, deferred revenue, uncertain income tax positions and property taxes. Actual results could differ from those estimates.

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)*****Fair Value Measurements***

The authoritative guidance 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:

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 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.

Pursuant to current authoritative guidance, entities are allowed an 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 the fair value option under this guidance as to specific assets or liabilities. There were no transfers between level 1, level 2 and level 3 inputs during the three and nine months ended October 1, 2011. The Company carries cash and cash equivalents at cost which approximates fair value. The following tables represent the Company's fair value hierarchy for its cash equivalents (in thousands):

	Fair Value Measurement as of October 1, 2011 using:			
	Level 1	Level 2	Level 3	Total
Assets:				
U.S. Treasuries	\$ 96,000	\$	\$	\$ 96,000
Money Market funds	1,373			1,373
Total	\$ 97,373	\$	\$	\$ 97,373

	Fair Value Measurement as of January 1, 2011 using:			
	Level 1	Level 2	Level 3	Total
Assets:				
U.S. Treasuries	\$ 57,995	\$	\$	\$ 57,995
Money Market funds	12,165			12,165
Total	\$ 70,160	\$	\$	\$ 70,160

***Accounts Receivable and Allowance for Doubtful Accounts***

Accounts receivable consist of trade receivables recorded upon recognition of revenue for product revenues, reduced by reserves for estimated bad debts and returns. Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Credit is extended based on

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evaluation of the customer's financial condition. Collateral is not required. The allowance for doubtful accounts is determined based on historical write-off experience, current customer information and other relevant factors, including specific identification of past due accounts, based on the age of the receivable in excess of the contemplated or contractual due date. Accounts are charged off against the allowance when the Company believes they are uncollectible.

### *Intangible Assets*

Costs to renew intangibles are capitalized and amortized over the remaining useful life of the intangible. For the three and nine months ended October 1, 2011, total renewal costs capitalized for patents were \$125,000 and \$324,000, respectively. For the three and nine months ended October 1, 2011, total renewal costs capitalized for trademarks were \$27,000 and \$44,000, respectively. As of October 1, 2011, the weighted average number of years until the next renewal is one year for patents and five years for trademarks.

The Company's policy is to renew its patents and trademarks. The Company continually evaluates the amortization period and carrying basis of patents and trademarks to determine whether any events or circumstances warrant a revised estimated useful life or reduction in value. Capitalized application costs are charged to operations when it is determined that the patent or trademark will not be obtained or is abandoned.

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**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)*****Revenue Recognition***

The Company follows the current authoritative guidance for revenue recognition. Based on these requirements, the Company recognizes revenue when: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the price is fixed or determinable, and (iv) collectability is reasonably assured. The Company enters into agreements to sell pulse oximetry and related products and services as well as multiple deliverable arrangements that include various combinations of products and services. While the majority of the Company's sales transactions contain standard business terms and conditions, there are some transactions that contain non-standard business terms and conditions. As a result, contract interpretation is sometimes required to determine the appropriate accounting, including: (a) whether an arrangement exists, (b) how the arrangement consideration should be allocated among the deliverables if there are multiple deliverables, (c) when to recognize revenue on the deliverables, and (d) whether undelivered elements are essential to the functionality of the delivered elements. Changes in judgments on these assumptions and estimates could materially impact the timing of revenue recognition.

In September 2009, the Financial Accounting Standards Board, or FASB, amended the accounting standards related to revenue recognition for arrangements with multiple deliverables. The new standard changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable to be based on relative selling prices. The FASB also amended the accounting standards for revenue recognition to exclude software that is contained in a tangible product from the scope of software revenue guidance if the software is essential to the tangible product's functionality. The Company adopted these new standards on a prospective basis. Therefore, the new standards apply only to revenue arrangements entered into or materially modified on or after January 2, 2011. For revenue arrangements that were entered into or materially modified after the adoption of these standards, implementation of this new authoritative guidance had no significant impact on the Company's reported revenue in either the three or nine months ended October 1, 2011 as compared to revenue if the related arrangements entered into or materially modified on or after January 2, 2011 were subject to the accounting requirements in effect in the same prior year periods.

The new standards establish a hierarchy to determine the selling price to be used for allocating revenue to deliverables as follows:

(i) vendor-specific objective evidence of fair value, or VSOE, (ii) third-party evidence of selling price, or TPE, and (iii) best estimate of the selling price, or ESP. VSOE is defined as the price charged when the same element is sold separately. VSOE generally exists only when the deliverable is sold separately and is the price actually charged for that deliverable. TPE generally does not exist for the majority of the Company's products because of their uniqueness. The objective of ESP is to determine the price at which the Company would transact a sale if the product was sold on a stand-alone basis. In the absence of VSOE and TPE, the Company determines ESP for its products by considering multiple factors including, but not limited to, features and functionality of the product, geographies, type of customer, contractual prices pursuant to Group Purchasing Organization, or GPO, contracts, the Company's pricing and discount practices and market conditions.

A deliverable in an arrangement qualifies as a separate unit of accounting if the delivered item has value to the customer on a stand-alone basis. Most of the Company's products in a multiple deliverable arrangement qualify as separate units of accounting. In the case of the Company's monitoring equipment products containing embedded Masimo SET software, the Company has determined that the hardware and software components function together to deliver the products' essential functionality, and therefore, represent a single deliverable. In accordance with the new guidance, the revenue from the sale of these products no longer falls within the scope of the software revenue recognition guidance. Software deliverables, such as rainbow<sup>®</sup> parameter software, which do not function together with hardware components to provide the products' essential functionality, continue to be accounted for under software revenue recognition guidance. The Company's multiple deliverable arrangements may therefore have software deliverables that are subject to the existing software revenue recognition guidance. The revenue for these multiple-element arrangements is allocated to the software deliverables and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy in the new revenue recognition accounting guidance for arrangements with multiple deliverables. The Company's sales under long-term sensor purchase contracts are generally structured such that the Company agrees to provide up-front and at no initial charge certain monitoring equipment, software, installation, training and ongoing warranty support in exchange for the hospital's agreement to purchase sensors over the term of the agreement, which ranges from three to six years. The sensors are essential to the functionality of the monitoring equipment and, therefore, represent a substantive performance obligation. The Company does not recognize any revenue when the monitoring and related equipment and software are delivered to the hospitals and installation and training is complete. The Company recognizes revenue for these delivered elements, on a pro-rata basis, as the sensors are delivered under the long-term purchase commitment. The adoption of the new guidance for revenue recognition did not change this pattern of revenue recognition for

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long-term sensor purchase contracts. The cost of the monitoring equipment initially placed at the hospitals is deferred and amortized to cost of goods sold over the life of the underlying long-term sensor purchase contract.

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)**

The Company's distributors purchase primarily sensor products which they then resell to hospitals that are typically fulfilling their purchase obligations to the Company under the end-user hospitals' long-term sensor purchase commitments. Upon shipment to the distributor, revenue is deferred until the Company's commitment to its end-user hospital is fulfilled, which occurs when the sensors are sold by the distributor to the end-user hospital. The Company also provides certain end-user hospitals with the ability to purchase sensors under rebate programs. Under these programs, the end-user hospitals may earn rebates based on their purchasing activity. The Company estimates and provides allowances for these programs at the time of sale as a reduction to revenue.

The Company also earns revenue from the sale of integrated circuit boards that use the Company's software technology and license fees for allowing certain OEMs the right to use the Company's technology in their products. The license fee is recognized upon shipment of the OEM's product to its customers, as represented to the Company by the OEM.

***Product Warranty***

The Company provides a warranty against defects in material and workmanship for a period ranging from six months to one year, depending on the product type. In the case of long-term sales agreements, the Company typically warrants the products for the term of the agreement, which ranges from three to six years. In traditional sales activities, including direct and OEM sales, the Company establishes an accrual for the estimated costs of warranty at the time of revenue recognition. Estimated warranty expenses are recorded as an accrued liability, with a corresponding provision to cost of sales. In long-term sales agreements, revenue related to extended warranty is recognized over the term of the extended warranty pursuant to its revenue recognition policy, while the product warranty costs related to the long-term sales agreements are expensed as incurred.

Changes in the product warranty accrual were as follows (in thousands):

	<b>Nine Months Ended</b>	
	<b>October 1, 2011</b>	<b>October 2, 2010</b>
Warranty accrual, beginning of period	\$ 544	\$ 354
Provision for warranty costs	1,919	1,790
Warranty expenditures	(1,823)	(1,650)
Warranty accrual, end of period	\$ 640	\$ 494

***Comprehensive Income***

Authoritative accounting guidance establishes requirements for reporting and disclosure of comprehensive income and its components. Comprehensive income includes foreign currency translation adjustments that have been excluded from net income including noncontrolling interests and reflected in Masimo Corporation stockholders' equity.

***Net Income Per Share***

Basic net income per share attributable to Masimo Corporation for the three and nine months ended October 1, 2011 and October 2, 2010 is computed by dividing net income attributable to Masimo Corporation by the weighted average number of shares outstanding during each period. The diluted net income per share attributable to Masimo Corporation for the three and nine months ended October 1, 2011 and October 2, 2010 is computed by dividing the net income attributable to Masimo Corporation by the weighted average number of shares and potential shares outstanding during each period, if the effect of potential shares is dilutive. Potential shares include incremental shares of stock issuable upon the

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exercise of stock options. For the three and nine months ended October 1, 2011, options to purchase 3,708,900 and 2,516,475 shares of common stock, respectively, were not included in the computation of diluted share equivalent because the options' exercise prices were greater than the average market price for the period. For the three and nine months ended October 2, 2010, options to purchase 3,643,020 and 3,189,620 shares of common stock, respectively, were not included in the computation of diluted share equivalent because the options' exercise prices were greater than the average market price for the period.



Table of Contents

## MASIMO CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The Company reduced its net income including noncontrolling interests by the amount of net (income) loss attributable to noncontrolling interests for the three and nine months ended October 1, 2011 and October 2, 2010. A reconciliation of basic and diluted net income per share attributable to Masimo Corporation is as follows (in thousands, except per share amounts):

	Three Months Ended		Nine Months Ended	
	October 1, 2011	October 2, 2010	October 1, 2011	October 2, 2010
<b>Net income attributable to stockholders of Masimo Corporation:</b>				
Net income including noncontrolling interests	\$ 14,824	\$ 16,694	\$ 49,887	\$ 56,774
Net (income) loss attributable to the noncontrolling interests	5	(275)	(7)	642
Net income attributable to Masimo Corporation	\$ 14,829	\$ 16,419	\$ 49,880	\$ 57,416
<b>Basic net income per share attributable to Masimo Corporation:</b>				
Net income attributable to Masimo Corporation	\$ 14,829	\$ 16,419	\$ 49,880	\$ 57,416
Weighted average shares outstanding - basic	59,971	58,866	59,804	58,644
<b>Basic net income per share attributable to Masimo Corporation</b>	<b>\$ 0.25</b>	<b>\$ 0.28</b>	<b>\$ 0.83</b>	<b>\$ 0.98</b>
<b>Diluted net income per share attributable to Masimo Corporation:</b>				
Weighted average shares outstanding - basic	59,971	58,866	59,804	58,644
Diluted share equivalent: stock options	1,115	1,706	1,278	1,883
Weighted average shares outstanding - diluted	61,086	60,572	61,082	60,527
<b>Diluted net income per share attributable to Masimo Corporation</b>	<b>\$ 0.24</b>	<b>\$ 0.27</b>	<b>\$ 0.82</b>	<b>\$ 0.95</b>

*New Accounting Pronouncements*

In May 2011, the FASB issued Accounting Standards Update No. 2011-04, or ASU 11-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU 11-04 provides a consistent definition of fair value and ensures that the fair value measurement and disclosure requirements are similar between U.S. GAAP and International Financial Reporting Standards. ASU 11-04 changes certain fair value measurement principles and enhances the disclosure requirements particularly for level 3 fair value measurements. This update is effective for interim and annual periods beginning after December 15, 2011 and should be applied prospectively. The Company does not expect the adoption of this update to have a material impact on its condensed consolidated financial statements.

In June 2011, the FASB issued Accounting Standards Update No. 2011-05, or ASU 11-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. ASU 11-05 requires an entity to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 11-05 eliminates the option to present the components of other comprehensive income as part of the statement of equity. ASU 11-05 is effective for interim and annual periods beginning after December 15, 2011, and should be applied retrospectively. Early adoption of this update is permitted. The Company does not expect the adoption of this update to have a material impact on its condensed consolidated financial statements, as it only requires a change in the format of presentation.

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In September 2011, the FASB issued Accounting Standards Update No. 2011-08, or ASU 11-08, *Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment*, to allow entities to use a qualitative approach to test goodwill for impairment. ASU 11-08 permits an entity to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed two-step goodwill impairment test. Otherwise, the two-step goodwill impairment test is not required. ASU 11-08 is effective for interim and annual periods beginning after December 15, 2011. Early adoption of this update is permitted. The Company does not expect the adoption of this update to have a material impact on its condensed consolidated financial statements.

Table of Contents

## MASIMO CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

**3. Comprehensive Income**

The Company's total comprehensive income attributable to Masimo Corporation is as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	October 1, 2011	October 2, 2010	October 1, 2011	October 2, 2010
Net income including noncontrolling interests	\$ 14,824	\$ 16,694	\$ 49,887	\$ 56,774
Other comprehensive income:				
Foreign currency translation gain	202	258	369	712
Total comprehensive income before noncontrolling interests	15,026	16,952	50,256	57,486
Net (income) loss attributable to the noncontrolling interests	5	(275)	(7)	642
Other comprehensive income attributable to noncontrolling interests				
Comprehensive income attributable to Masimo Corporation	\$ 15,031	\$ 16,677	\$ 50,249	\$ 58,128

**4. Variable Interest Entities (VIEs)**

The Company follows authoritative guidance for the consolidation of VIEs, which requires an enterprise to determine whether its variable interest gives it a controlling financial interest in a VIE. This consolidation guidance for VIEs replaced the prior *quantitative* approach for identifying whether an enterprise should consolidate a VIE with a *qualitative* approach. Determination about whether an enterprise should consolidate a VIE is required to be evaluated continuously as changes to existing relationships or future transactions may result in consolidating or deconsolidating the VIE.

**Cercacor Laboratories, Inc.**

Cercacor Laboratories, Inc., or Cercacor, is an independent entity spun off from the Company to its stockholders in 1998. Joe Kiani and Jack Lasersohn, members of the Company's board of directors, or the Board, are also members of the board of directors of Cercacor. Joe Kiani, the Company's Chairman and Chief Executive Officer, is also the Chairman and Chief Executive Officer of Cercacor. The Company is a party to a Cross-Licensing Agreement with Cercacor, which was most recently amended and restated effective January 1, 2007, that governs each party's rights to certain intellectual property held by the two companies.

Under the Cross-Licensing Agreement, the Company granted Cercacor an exclusive, perpetual and worldwide license, with sublicense rights, to use all Masimo SET owned by the Company, including all improvements on this technology, for the monitoring of non-vital signs measurements and to develop and sell devices incorporating Masimo SET for monitoring non-vital signs measurements in any product market in which a product is intended to be used by a patient or pharmacist rather than a professional medical caregiver. The Company refers to this market as the Cercacor Market. The Company also granted Cercacor a non-exclusive, perpetual and worldwide license, with sublicense rights to use all Masimo SET for the measurement of vital signs in the Cercacor Market.

The Company exclusively licenses from Cercacor the right to make and distribute products in the professional medical caregiver markets, which the Company refers to as the Masimo Market, that utilize rainbow<sup>®</sup> technology for the measurement of carbon monoxide, methemoglobin, fractional arterial oxygen saturation, and total hemoglobin, which includes hematocrit. To date, the Company has developed and commercially released devices that measure carbon monoxide, methemoglobin and total hemoglobin using licensed rainbow<sup>®</sup> technology. The Company also has the option to obtain the exclusive license to make and distribute products that utilize rainbow<sup>®</sup> technology for the monitoring of other

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non-vital signs measurements, including blood glucose, in product markets where the product is intended to be used by a professional medical caregiver.

From May 1998 through May 2009, Cercacor contracted the services of the Company's employees for the development of rainbow® technology. The Company paid Cercacor for the option to market and develop products based on Cercacor technology in defined markets. Through December 2005, the Company paid Cercacor \$7.5 million in option fees. Nearly all these option fees were used by Cercacor to repay the Company for the services that the Company had provided to Cercacor. In addition, through September 2009, the Company exercised its options to three licenses, for \$2.5 million each, for the right to market products based on the new carbon monoxide, methemoglobin and total hemoglobin parameter technologies developed by Cercacor. Effective as of January 1, 2007, the Company entered into a Services Agreement with Cercacor to govern the general and administrative services the Company provides to Cercacor.

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)**

The Company's license to rainbow® technology for these parameters in these markets is exclusive on the condition that the Company continues to pay Cercacor royalties on its products incorporating rainbow® technology, subject to certain minimum aggregate royalty thresholds, and that the Company use commercially reasonable efforts to develop or market products incorporating the licensed rainbow® technology. The royalty is up to 10% of the rainbow® royalty base, which includes handhelds, tabletop and multi-parameter devices. Handheld products incorporating rainbow® technology will carry a 10% royalty rate. For other products, only the proportional amount attributable to that portion of the Company's products used to monitor non-vital signs measurements, sensors and accessories, rather than for monitoring vital signs measurements, will be included in the 10% rainbow® royalty base. Effective January 2009, for multi-parameter devices, the rainbow® royalty base will include the percentage of the revenue based on the number of rainbow® enabled measurements. For hospital contracts where the Company places equipment and enters into a sensor contract, the Company pays a royalty to Cercacor on the total sensor contract revenues based on the ratio of rainbow® enabled devices to total devices.

In 2010 and thereafter, the Company is subject to an annual minimum aggregate royalty payment of \$5.0 million. The aggregate royalty payments were \$1.3 million and \$3.8 million for the three and nine months ended October 1, 2011, respectively, and \$1.3 million and \$3.8 million for the three and nine months ended October 2, 2010, respectively. In addition, in connection with a change in control, as defined in the Cross-Licensing Agreement, the minimum aggregate annual royalties for all licensed rainbow® measurements payable to Cercacor will increase up to \$15.0 million per year for 2011 and thereafter and up to \$2.0 million per year for other rainbow® measurements.

In February 2009, in order to accelerate the product development of an improved spot-check measurement device, Pronto-7, the Company's board of directors agreed to pay certain of Cercacor's engineering expenses to assist in these efforts. Specifically, these expenses included third party engineering materials and supplies expense as well as 50% of Cercacor's total engineering and engineering related payroll expenses from April 2009 through June 2010, the original anticipated completion date of this product development effort. Since July 2010, Cercacor has continued to assist the Company with product development efforts and charged the Company accordingly. During the three and nine months ended October 1, 2011, and until both parties agree to end these services, Cercacor assisted and will continue to assist the Company with continuing productization efforts of the new handheld noninvasive multi-parameter spot-check testing device. During the three and nine months ended October 1, 2011, the total expenses for these additional services, material and supplies totaled \$541,000 and \$1.9 million, respectively. During the three and nine months ended October 2, 2010, these expenses totaled \$557,000 and \$2.0 million, respectively.

The condensed consolidated balance sheets include a noncontrolling interest in Cercacor of \$2.5 million as of October 1, 2011 and \$2.4 million as of January 1, 2011, which represents the value of common stock, additional paid in capital and retained earnings of Cercacor, which are not available to the Company. In addition, the condensed consolidated balance sheets include, net of intercompany eliminations, total assets of \$5.3 million and \$5.4 million as of October 1, 2011 and January 1, 2011, respectively, related to Cercacor. Cercacor's total assets as of October 1, 2011 included \$2.5 million for intangible assets, \$1.2 million for property and equipment and \$1.1 million of deferred tax assets. Its total assets as of January 1, 2011 included \$2.1 million for intangible assets, \$1.2 million for property and equipment and \$1.1 million of deferred tax assets. The condensed consolidated balance sheets include total liabilities, net of intercompany eliminations, of \$1.0 million and \$1.5 million as of October 1, 2011 and January 1, 2011, respectively, related to Cercacor.

Pursuant to authoritative accounting guidance, Cercacor is consolidated within the Company's financial statements for all periods presented. The Company is required to consolidate Cercacor since the Company was deemed to be the primary beneficiary of Cercacor's activities. This determination is based on the Company's significant influence over the operations and decision making of Cercacor. Accordingly, all intercompany royalties, option and license fees and other charges between the Company and Cercacor as well as all intercompany payables and receivables have been eliminated in the consolidation. Also, all direct engineering expenses that have been incurred by the Company and charged to Cercacor have not been eliminated and are included as research and development expense in the Company's condensed consolidated statements of income. Upon consolidation, \$3.3 million and \$3.9 million of receivables due from the Company as of October 1, 2011 and January 1, 2011, respectively, were eliminated. Also upon consolidation, \$5.4 million and \$5.7 million of deferred revenue related to technology licensed to the Company as of October 1, 2011 and January 1, 2011, respectively, were eliminated. Assets of Cercacor can only be used to settle obligations of Cercacor and creditors of Cercacor have no recourse to the general credit of the Company.

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For the foreseeable future, the Company anticipates that it will continue to consolidate Cercacor pursuant to the current authoritative accounting guidance; however, in the event that Cercacor is no longer considered a VIE or in the event that the Company is no longer the primary beneficiary of Cercacor, the Company may discontinue consolidating the entity.

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)**

The changes in noncontrolling interest for Cercacor are as follows (in thousands):

	<b>Nine Months Ended October 1, 2011</b>
Noncontrolling interest, beginning of period	\$ 2,394
Increase in additional paid-in capital of noncontrolling interest	63
Net income attributable to noncontrolling interest	7
Other comprehensive income attributable to noncontrolling interest	
<b>Noncontrolling interest, end of period</b>	<b>\$ 2,464</b>

***SEDLine, Inc.***

During the six months ended July 3, 2010, SEDLine, Inc., or SEDLine, was considered to be a VIE and the Company was deemed to be the primary beneficiary. Therefore, the Company included SEDLine's revenue and expenses incurred during the six months ended July 3, 2010 in its condensed consolidated statement of income for the period. However, SEDLine was a noncontrolling interest of the Company, and therefore its net losses incurred during the six months ended July 3, 2010, were not included in the net income attributable to the Company.

On July 2, 2010, the Company acquired SEDLine and as a result, SEDLine became a wholly-owned subsidiary and was no longer a noncontrolling interest of the Company. For the three months ended October 2, 2010, due to SEDLine's change in status, the Company included SEDLine's revenue, expenses and results thereof in its condensed consolidated statement of income. For the three and nine months ended October 1, 2011, the Company continued to include SEDLine's revenue, expenses and results thereof in its condensed consolidated statements of income. As of October 1, 2011 and January 1, 2011, since SEDLine was a wholly-owned subsidiary, all of SEDLine's assets, liabilities and equity were consolidated with the Company.

**5. Related Party Transactions**

As of October 1, 2011 and January 1, 2011, the Company had amounts due from employees of \$167,000 and \$180,000, respectively, which are classified in other assets in the accompanying condensed consolidated balance sheets.

The Company's Chief Executive Officer is also the Chairman of the Masimo Foundation for Ethics, Innovation and Competition in Healthcare, or the Masimo Foundation, a non-profit organization which was founded during the first quarter of 2010 to benefit worldwide healthcare. The Company's Chief Financial Officer is also a Director of the Masimo Foundation. For the three and nine months ended October 2, 2010, the Company contributed a total of \$0 and \$10.3 million, respectively, to the Masimo Foundation, which has been recorded within selling, general and administrative expenses in the condensed consolidated statements of income. No amounts were contributed to the Masimo Foundation during the three or nine months ended October 1, 2011.

**6. Cash and Cash Equivalents**

The Company considers all highly liquid investments with an original maturity from date of purchase of three months or less, or highly liquid investments that are readily convertible into known amounts of cash, to be cash equivalents. As of October 1, 2011, the Company's cash balance was \$45.8 million, which was comprised of checking and savings accounts. Additionally, the Company had cash equivalents of \$97.4 million, consisting of \$96.0 million of U.S. Treasury bills and \$1.4 million of money market funds.

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As of January 1, 2011, the Company's cash balance was \$18.1 million, comprised of checking accounts. Additionally, the Company had cash equivalents of \$70.2 million, consisting of \$58.0 million of U.S. Treasury bills and \$12.2 million of money market funds.

In March 2010, the Company received \$27.0 million from the sale of specific short-term investments classified as held-to-maturity, prior to their maturity date. The proceeds were used to pay a portion of the special dividend that the Company declared in February 2010. The realized loss on the sale of these short-term investments was de minimis.



**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)****7. Royalties Receivable**

The royalty receivable of \$6.7 million as of October 1, 2011 represents the Company's estimated amount due for the three months ended October 1, 2011. Pursuant to the second amendment to its settlement agreement with Nellcor Puritan Bennett, Inc. (currently Covidien Ltd., or Covidien), the royalties are paid to the Company based on a percentage of sales of Covidien U.S. based pulse oximetry products. The Company recognizes royalty revenue based on the royalty rate per the second amendment to its settlement agreement, multiplied by its estimate of Covidien's sales for each quarter. Any adjustments to the quarterly estimate are recorded prospectively in the following quarter, when the Company receives the Covidien royalty report and payment, which is generally 60 days after the end of each of Covidien's fiscal quarters.

**8. Inventories**

Inventories are stated at the lower of cost or market. Cost is determined using a standard cost method, which approximates FIFO (first-in, first-out) and includes material, labor and overhead. Inventory valuation allowances are recorded for materials that have become obsolete or are no longer used in current production and for inventory that has a market value less than the carrying value in inventory. Inventories consist of the following (in thousands):

	October 1, 2011	January 1, 2011
Raw materials	\$ 26,425	\$ 28,028
Work in-process	4,665	4,192
Finished goods	14,433	12,808
Total	\$ 45,523	\$ 45,028

**9. Capital Lease Obligations**

Capital lease obligations consist of the following not including interest expense (in thousands):

	October 1, 2011	January 1, 2011
Capital lease obligations, current portion	\$ 48	\$ 50
Capital lease obligations, long-term portion	87	122
Total capital lease obligations	\$ 135	\$ 172

The Company currently has three capital leases related to office equipment. These leases have interest rates ranging from 5.2% to 6.6% per year and mature on various dates from December 2012 through May 2014. As of October 1, 2011, the total future remaining interest cost under all capital leases was \$1,000.

**10. Share-Based Compensation**

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On August 7, 2007, in connection with the Company's initial public offering, the 2007 Stock Incentive Plan, or the 2007 Plan, became effective. Under the 2007 Plan, 3,000,000 shares of common stock were initially reserved for future issuance, plus shares available under the prior year equity incentive plans, including shares that become available under the 2007 Plan due to forfeitures at prices not less than the fair market value of the Company's common stock on the date the option is granted. The options generally vest annually over five years using the straight-line method, unless otherwise provided, and expire ten years from the date of grant. Options forfeited under the 2007 Plan and the Company's other option plans are automatically added to the share reserve of the 2007 Plan.

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)**

During the fiscal year ended January 1, 2011, the Company issued 1,586,519 shares of common stock as a result of stock option exercises. The number and weighted average exercise price of options issued and outstanding under all stock option plans are as follows:

	<b>Nine Months Ended October 1, 2011</b>	
	<b>Shares</b>	<b>Average Exercise Price</b>
Options outstanding, beginning of period	6,941,182	\$ 21.32
Granted	850,525	\$ 29.99
Canceled	(225,370)	\$ 27.52
Exercised	(540,322)	\$ 10.30
Options outstanding, end of period	7,026,015	\$ 23.02
Options exercisable, end of period	3,577,030	\$ 18.92
Options available for grant, end of period	4,833,283	

The Black-Scholes option pricing model is used to estimate the fair value of options granted under the Company's share-based compensation plans. The range of assumptions used and the resulting weighted-average fair value of options granted at the date of grant were as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2011</b>	<b>October 2, 2010</b>	<b>October 1, 2011</b>	<b>October 2, 2010</b>
Risk-free interest rate	1.0% to 1.9%	1.4% to 2.0%	1.0% to 2.5%	1.4% to 2.9%
Expected term	5.3 years	5.5 years	5.3 years	5.5 years
Estimated volatility	36.7% to 41.8%	39.9% to 41.0%	36.7% to 41.8%	37.4% to 41.4%
Expected dividends	0%	0%	0%	0%
Weighted-average fair value of options granted	\$10.34	\$9.58	\$11.50	\$10.44

The aggregate intrinsic value of options outstanding, with an exercise price less than the closing price of the Company's common stock, as of October 1, 2011 was \$25.1 million and had a weighted average remaining contractual term of 4.4 years. The aggregate intrinsic value of options exercisable, with an exercise price less than the closing price of the Company's common stock, as of October 1, 2011 was \$23.5 million and had a weighted average remaining contractual term of 4.2 years. The aggregate intrinsic value of options exercised during the nine months ended October 1, 2011, was \$10.8 million. The aggregate intrinsic value is calculated as the difference between the market value of the Company's common stock on the date of exercise or the respective period end, as appropriate, and the exercise price of the options. The unrecognized share-based compensation as of October 1, 2011 was \$38.8 million related to unvested options granted after January 1, 2006.

The following table presents the total share-based compensation expense that is included in each functional line item of the condensed consolidated statements of income (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2011</b>	<b>October 2, 2010</b>	<b>October 1, 2011</b>	<b>October 2, 2010</b>
Cost of goods sold	\$ 138	\$ 140	\$ 419	\$ 351

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Selling, general and administrative	1,912	1,778	7,559	6,514
Research and development	543	651	2,189	2,022
Total	\$ 2,593	\$ 2,569	\$ 10,167	\$ 8,887

### 11. Commitments and Contingencies

#### *Leases*

The Company leases its facilities in North America, Europe and Asia under operating lease agreements expiring at various dates through September 2014. Certain facilities leases contain predetermined price escalations. The Company recognizes the lease costs using a straight-line method based on total lease payments. The Company also received certain leasehold improvement incentives totaling \$650,000 for its headquarters facilities in the U.S. These leasehold improvement incentives

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)**

have been recorded as deferred rent and are being amortized as a reduction to rent expense on a straight-line basis over the life of the lease. As of October 1, 2011 and January 1, 2011, rent expense accrued in excess of the amount paid aggregated \$305,000 and \$193,000, respectively, and is classified in other liabilities. The Company also leases automobiles in Europe that are classified as operating leases and expire at various dates through April 2014.

Future minimum lease payments under operating and capital leases for each of the following fiscal years ending on or about December 31 are (in thousands):

	As of October 1, 2011		
	Operating Leases	Capital Leases	Total
2011 (balance of year)	\$ 872	\$ 13	\$ 885
2012	2,723	54	2,777
2013	2,399	49	2,448
2014	1,512	20	1,532
Thereafter			
Total	\$ 7,506	\$ 136	\$ 7,642

Rental expense related to operating leases was \$958,000 and \$2.8 million for the three and nine months ended October 1, 2011, respectively, and \$869,000 and \$2.7 million for the three and nine months ended October 2, 2010, respectively.

***Employee Retirement Savings Plan***

In fiscal year 1996, the Company adopted the Masimo Retirement Savings Plan, or the Plan, which is a 401(k) plan covering all of the Company's full-time U.S. employees who meet certain eligibility requirements. The Company contributes to the Plan on a discretionary basis. The Company contributed \$312,000 and \$926,000 to the Plan for the three and nine months ended October 1, 2011, respectively, and \$311,000 and \$875,000 to the Plan for the three and nine months ended October 2, 2010, respectively.

***Employment and Severance Agreement***

As of October 1, 2011, the Company had an employment agreement with one of its key employees that provides for an aggregate annual base salary with annual increases at the discretion of the Compensation Committee of the board of directors, plus other benefits. The agreement with the Company also provides for an annual bonus based on the Company's attainment of certain financial and other objectives and goals. The agreement has an initial term of three years, with automatic daily renewal, unless either the Company or the executive notifies the other party of non-renewal of the agreement. Also, under this employment agreement, the key employee may be entitled to receive certain salary, equity, tax, medical and life insurance benefits if he is terminated by the Company, if he terminates his employment for good reason under certain circumstances or if there is a change in control of the Company.

As of October 1, 2011, the Company had severance plan participation agreements with three of its executive officers. The participation agreements, or Agreements, are governed by the terms and conditions of the Company's 2007 Severance Protection Plan, or Severance Plan, which became effective on July 19, 2007 and was amended effective December 31, 2008. Under the Agreements, each executive officer may be entitled to receive certain salary, equity, medical and life insurance benefits if he is terminated by the Company without cause or terminates his employment for good reason under certain circumstances. The executive officers are also required to give the Company six months advance notice of their resignation under certain circumstances.

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As of October 1, 2011, the Company had limited severance plan participation agreements with four of its executive officers. These limited participation agreements, or Limited Agreements, are governed by the terms and conditions of the Severance Plan. Under the Limited Agreements, 50% of the executive officer's unvested and outstanding stock options will immediately vest if the executive officer is terminated by the Company upon a change in control under certain circumstances. The executive officers are also required to give the Company six months advance notice of their resignation under certain circumstances.

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**Table of Contents**

**MASIMO CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(unaudited)**

***Purchase Commitments***

Pursuant to contractual obligations with vendors, the Company had \$40.1 million of purchase commitments as of October 1, 2011, all of which is expected to be purchased within one year. These purchase commitments were made for certain inventory items to secure better pricing and to ensure the Company will have raw materials when necessary.

***Concentrations of Risk***

The Company is exposed to credit loss for the amount of cash deposits with financial institutions in excess of federally insured limits. As of October 1, 2011, the Company had \$45.8 million of bank balances, of which \$15.7 million was covered by the Federal Deposit Insurance Corporation limit. The Company invests its excess cash deposits in U.S. Treasury bills and money market accounts with major financial institutions. As of October 1, 2011, the Company had \$96.0 million in U.S. Treasury bills which are guaranteed by the U.S. federal government and \$1.4 million in money market funds that are not guaranteed by the U.S. federal government.

While the Company and its contract manufacturers rely on sole source suppliers for certain components, steps have been taken to minimize the impact of a shortage or stoppage of shipments, such as maintaining excess inventory and designing products that may be easily modified to use a different component. However, there can be no assurance that a shortage or stoppage of shipments of the materials or components that the Company purchases will not result in a delay in production, or adversely affect the Company's business.

The Company's ability to sell its products to U.S. hospitals depends in part on its relationships with GPOs. Many existing and potential customers for the Company's products become members of GPOs. GPOs negotiate pricing arrangements and contracts, sometimes exclusively, with medical supply manufacturers and distributors, and these negotiated prices are made available to a GPO's affiliated hospitals and other members. During the three and nine months ended October 1, 2011, revenue from the sale of the Company's pulse oximetry products to U.S. hospitals that are members of GPOs amounted to \$55.2 million and \$166.7 million, respectively. During the three and nine months ended October 2, 2010, revenue from the sale of the Company's pulse oximetry products to U.S. hospitals that are members of GPOs amounted to \$45.6 million and \$133.7 million, respectively.

For the three months ended October 1, 2011, the Company had sales through two just-in-time distributors, each of which represented 14.3% and 9.9% of the total revenue, respectively. For the nine months ended October 1, 2011, the Company had sales through two just-in-time distributors, each of which represented 14.0% and 10.0% of the total revenue, respectively. For the three and nine months ended October 2, 2010, sales through one just-in-time distributor represented 16.3% and 14.0% of the total revenue, respectively. For both periods, the just-in-time distributors take and fulfill orders from the Company's direct customers, many of whom have signed long-term sensor agreements with the Company. In the event a distributor is unable to fulfill these orders, the orders would be redirected to other distributors or fulfilled directly by the Company.

As of October 1, 2011, one just-in-time distributor represented 7.2% of the accounts receivable balance and another just-in-time distributor represented 5.6% of the accounts receivable balance. As of January 1, 2011, one just-in-time distributor represented 5.3% of the accounts receivable balance.

***Litigation***

On February 3, 2009, the Company filed a patent infringement suit against Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH related to Philips' FAST pulse oximetry technology and certain of Philips patient monitors. The suit was brought in the U.S. District Court for the District of Delaware. Two patents originally asserted in this suit, related to the Company's measure-through motion technology, were successfully enforced in the Company's previous suit against Nellcor. On June 15, 2009, Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH answered the Company's complaint and Philips Electronics North America Corporation filed antitrust and patent infringement counterclaims against the Company as well as counterclaims seeking declaratory judgments of invalidity on the patents asserted by the Company against Philips. On July 9, 2009, the Company filed its answer denying Philips

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counterclaims and asserting various defenses. The Company also asserted counterclaims against Philips for fraud, intentional interference with prospective economic advantage and for declaratory judgments of noninfringement and invalidity with respect to the patents asserted by Philips against the Company. Philips later added a claim for infringement of one additional patent. Subsequently, the Court bifurcated Philips' antitrust claims and its patent misuse defense, as well as stayed the discovery phase on those claims pending trial in the patent case. On October 4, 2010, the Court limited the number of patents to be construed to four for the Company and three for Philips. Further, on October 6, 2010, the Court denied Philips' motion to bifurcate and stay damages in the patent case. In December 2010, the Court held a hearing regarding the construction of



**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)**

the patent claims and the Magistrate Judge issued a Report and Recommendation on claim construction on February 18, 2011. The parties are awaiting the claim construction order from the District Court Judge. The Company believes that it has good and substantial defenses to the antitrust and patent infringement claims asserted by Philips. There is no guarantee that the Company will prevail in this suit or receive any damages or other relief if it does prevail.

From time to time, the Company may be involved in other litigation relating to claims arising out of its operations in the normal course of business. The Company believes that it currently is not a party to any other legal proceedings which, individually or in the aggregate, would have a material adverse effect on its consolidated financial position, results of operations or cash flows.

**12. Segment Information and Enterprise Reporting**

The Company's chief decision maker, the Chief Executive Officer, reviews financial information presented on a consolidated basis, accompanied by disaggregated information about revenues by geographic region for purposes of making operating decisions and assessing financial performance. Accordingly, the Company considers itself to be in a single reporting segment, specifically noninvasive patient monitoring solutions and related products. The Company does not assess the performance of its geographic regions on other measures of income or expense, such as depreciation and amortization, operating income or net income including noncontrolling interests. In addition, the Company's assets are primarily located in the U.S. The Company does not produce reports for, or measure the performance of, its geographic regions on any asset-based metrics. Therefore, geographic information is presented only for revenues.

The following schedule presents an analysis of the Company's product revenues based upon the geographic area to which the product was shipped (in thousands, except percentages):

<b>Geographic Area by Destination</b>	<b>Three Months Ended</b>				<b>Nine Months Ended</b>			
	<b>October 1, 2011</b>		<b>October 2, 2010</b>		<b>October 1, 2011</b>		<b>October 2, 2010</b>	
North and South America	\$ 73,295	75.1%	\$ 68,705	77.4%	\$ 225,311	74.7%	\$ 199,224	75.9%
Europe, Middle East and Africa	12,947	13.2	11,379	12.8	42,906	14.2	35,605	13.5
Asia and Australia	11,397	11.7	8,739	9.8	33,554	11.1	27,818	10.6
<b>Total product revenue</b>	<b>\$ 97,639</b>	<b>100%</b>	<b>\$ 88,823</b>	<b>100%</b>	<b>\$ 301,771</b>	<b>100%</b>	<b>\$ 262,647</b>	<b>100%</b>
United States	\$ 70,343		\$ 66,231		\$ 214,216		\$ 190,202	

**13. Income Taxes**

As of October 1, 2011, the balance of the gross unrecognized tax benefit was \$8.5 million, of which \$7.5 million (net of federal benefit on state taxes), if recognized, would affect the effective tax rate. As of January 1, 2011, the balance of the gross unrecognized tax benefit was \$7.5 million, of which \$6.5 million (net of federal benefit on state taxes), if recognized, would affect the effective tax rate. The remaining balance relates to timing differences. It is reasonably possible that the amount of unrecognized tax benefits in various jurisdictions may change in the next twelve months due to the expiration of statutes of limitation and audit settlements. However, due to the uncertainty surrounding the timing of these events, an estimate of the change within the next twelve months cannot currently be made.

Interest and penalties related to unrecognized tax benefits are recognized in income tax expense. For the three and nine months ended October 1, 2011, the Company expensed \$75,000 and \$212,000, respectively, for interest. For the three and nine months ended October 2, 2010, the Company credited \$34,000 and expensed \$135,000, respectively, for interest.

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The Company conducts business in multiple jurisdictions, and as a result, one or more of the Company's subsidiaries files income tax returns in the U.S. federal, various state, local and foreign jurisdictions. The Company has concluded all U.S. federal income tax matters for each year through 2007. All material state, local and foreign income tax matters have been concluded for each year through 2004.

**Table of Contents**

**MASIMO CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**(unaudited)**

The provision for income taxes was \$3.9 million and \$17.0 million, or an effective tax rate of 20.7% and 25.5%, for the three and nine months ended October 1, 2011, respectively. The provision for income taxes was \$7.4 million and \$29.1 million, or an effective tax rate of 30.6% and 33.9%, for the three and nine months ended October 2, 2010, respectively. The effective tax rate differs from the statutory U.S. federal income tax rate of 35% primarily due to state taxes, permanent differences between pre-tax income for financial reporting purposes and taxable income, research related tax credits, the recognition of tax benefits related to uncertain tax positions and anticipated income in jurisdictions in which the Company does business with different effective tax rates.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This Quarterly Report on Form 10-Q contains forward-looking statements as defined in Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, in connection with the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially and adversely from those expressed or implied by such forward-looking statements. Such forward-looking statements include any expectation of earnings, revenues or other financial items; any statements of the plans, strategies and objectives of management for future operations; factors that may affect our operating results or financial condition; statements concerning new products, technologies or services; statements related to future capital expenditures; statements related to future economic conditions or performance; statements related to our stock repurchase program; statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as anticipate, believe, continue, could, estimate, expect, intend, may, or will, and similar expressions or variations. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially and adversely from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included elsewhere in this Quarterly Report Form 10-Q and in our other Securities and Exchange Commission, or SEC, filings, including our Annual Report on Form 10-K for the fiscal year ended January 1, 2011, which we filed with the SEC on February 16, 2011. Furthermore, such forward-looking statements speak only as of the date of this report. We undertake no obligation to update any forward-looking statements to reflect events or circumstances occurring after the date of such statements.*

**Overview**

We are a global medical technology company that develops, manufactures and markets noninvasive patient monitoring products that help clinicians improve patient care. We invented Masimo Signal Extraction Technology, or Masimo SET, which provides the capabilities of Measure-Through Motion and Low Perfusion pulse oximetry to address the primary limitations of conventional pulse oximetry. Pulse oximetry is the noninvasive measurement of the oxygen saturation level of arterial blood, or the blood that delivers oxygen to the body's tissues, and pulse rate. Conventional pulse oximetry is subject to technological limitations that reduce its effectiveness and the quality of patient care. In particular, when using conventional pulse oximetry, arterial blood signal recognition can be distorted by motion artifact, or patient movement, and low perfusion, or low arterial blood flow. Low perfusion can also cause the failure of the conventional pulse oximeter to obtain an accurate measurement. Conventional pulse oximetry readings can also be impacted by bright light and electrical interference from the presence of electrical surgical equipment. Published independent research shows that over 70% of the alarms were false outside the operating room using conventional pulse oximetry. Our Masimo SET platform has addressed many of the previous technology limitations. The benefits of Masimo SET have been validated in over 100 independent clinical and laboratory studies.

We develop, manufacture and market a family of noninvasive blood constituent patient monitoring solutions that consists of a monitor or circuit board and our proprietary single-patient use and reusable sensors and cables. In addition, we offer remote-monitoring and clinician notification solutions. Although our Masimo SET platform is only operable with our proprietary sensors, our sensors have the capability to work with certain competitor pulse oximeters through the use of our adapter cables. In 2005, we launched our Masimo rainbow<sup>®</sup> Pulse CO-Oximetry platform utilizing licensed rainbow<sup>®</sup> technology from Cercacor Laboratories, Inc., or Cercacor, which enables the noninvasive and continuous measurement of not only arterial blood oxygen saturation level and pulse rate, but also carboxyhemoglobin, or carbon monoxide levels in the blood, methemoglobin (released in 2006) saturation levels in the blood and total hemoglobin (released in 2008), or the oxygen-carrying component of red blood cells. In 2007, we launched PVI, which is a measurement that quantifies changes in the plethysmographic waveform over the respiration cycle. Along with the release of our Masimo rainbow<sup>®</sup> Pulse CO-Oximetry products, we have developed multi-wavelength sensors that have the ability to monitor multiple measurements with a single sensor. In October 2008, we received clearance from the U.S. Food and Drug Administration, or FDA, for Pronto, a handheld noninvasive multi-parameter testing device, not a continuous monitoring device, that uses Masimo rainbow<sup>®</sup> SET technology, to provide pulse oximetry, pulse rate, perfusion index and spot-checking of total hemoglobin levels. In November 2009, we received FDA clearance for rainbow Acoustic Monitoring<sup>™</sup> for continuous and noninvasive monitoring of respiration rate, which is the number of breaths per minute. In December 2009, we announced initial limited market release of this measurement that allowed us to evaluate the product's performance in the field. We began a full commercial release of rainbow Acoustic Monitoring<sup>™</sup> in June 2010. Also, in June 2010, we received FDA clearance for Pronto-7, a handheld noninvasive multi-parameter testing device, that provides spot-check hemoglobin testing along with oxygen saturation, pulse rate and perfusion index results. In October 2011, we announced FDA clearance and CE Mark of a new Radical-7<sup>®</sup> with rainbow Acoustic Monitoring<sup>™</sup>. Also new to the Radical-7 is an In Vivo Adjustment<sup>™</sup> (pending FDA clearance in the U.S.) that allows clinicians, for the first time, to adjust the noninvasive measurements to the specific patient and laboratory reference device they use for invasive blood testing.



**Table of Contents**

We have focused on building our U.S. and international sales and marketing infrastructure to market our products to end-users, such as hospitals, and to original equipment manufacturer, or OEM, partners for incorporation into their patient-monitoring products. We market our pulse oximetry products to hospitals and the alternate care market through our direct sales force, and market our circuit boards to our OEM partners. Today, the primary focus of our hospital sales force is to facilitate the conversion of hospitals to our Masimo SET or Masimo rainbow® SET products. In the U.S., we typically enter into long-term sales contracts with hospitals, pursuant to which we ship and install our pulse oximeters at no up-front cost to the hospital in exchange for a commitment to purchase a minimum number of sensors from us over a specified period of time. With the introduction of Masimo rainbow® Pulse CO-Oximetry, we have established a sales force to concentrate on the alternate care market. Over the past year, we have expanded our sales and marketing staffing levels. We supplement our direct sales with sales through our distributors, who, within the U.S., function as inventory or fulfillment houses for our hospital customers. Direct and distributor sales have increased to \$252.7 million, or 83.7%, of product revenue for the nine months ended October 1, 2011, from \$206.2 million, or 78.5%, of product revenue for the nine months ended October 2, 2010.

The building of our installed base of pulse oximeters and pulse oximeter circuit boards generates recurring sales of our sensors, primarily single-patient use sensors. A user of one of our pulse oximeters or our OEMs pulse oximeters can obtain the benefit of the Masimo SET or Masimo rainbow® SET only by using our proprietary sensors that are designed for our system. We currently estimate that our worldwide installed base was 950,000 units, based on an estimated 10 year field life assumption, as of October 1, 2011, up from 821,000 units as of October 2, 2010. We estimate our installed base to be the number of pulse oximeters and pulse oximeter circuit boards that we have shipped in the past 10 years. We expect our worldwide installed base to continue to increase as we expand our market share and expand the pulse oximetry market to other patient care settings.

***Cercacor Laboratories, Inc.***

Cercacor Laboratories, Inc., or Cercacor, is an independent entity spun off from us to our stockholders in 1998. Joe Kiani and Jack Lasersohn, members of our board of directors, are also members of the board of directors of Cercacor. Joe Kiani, our Chairman and Chief Executive Officer, is also the Chairman and Chief Executive Officer of Cercacor. We are a party to a cross-licensing agreement with Cercacor, which was amended and restated effective January 1, 2007, or the Cross-Licensing Agreement, that governs each party's rights to certain intellectual property held by the two companies.

Under the Cross-Licensing Agreement, we granted Cercacor an exclusive, perpetual and worldwide license, with sublicense rights to use all Masimo SET owned by us, including all improvements on this technology, for the monitoring of non-vital signs measurements and to develop and sell devices incorporating Masimo SET for monitoring non-vital signs measurements in any product market in which a product is intended to be used by a patient or pharmacist, which we refer to as the Cercacor Market, rather than a professional medical caregiver. We also granted Cercacor a non-exclusive, perpetual and worldwide license, with sublicense rights to use all Masimo SET for the measurement of vital signs in the Cercacor Market.

We exclusively license from Cercacor the right to make and distribute products in the professional medical caregiver markets, which we refer to as the Masimo Market, that utilize rainbow® technology for the measurement of carbon monoxide, methemoglobin, fractional arterial oxygen saturation and total hemoglobin, which includes hematocrit. To date, we have developed and commercially released devices that measure carbon monoxide, methemoglobin and total hemoglobin using licensed rainbow® technology. We also have the option to obtain the exclusive license to make and distribute products that utilize rainbow® technology for the monitoring of other non-vital signs measurements, including blood glucose, in product markets where the product is intended to be used by a professional medical caregiver.

In February 2009, in order to accelerate the product development of our spot-check measurement device, we agreed to pay certain of Cercacor's engineering expenses to assist in these efforts. Specifically, these expenses included third party engineering materials and supplies expense, as well as 50% of Cercacor's total engineering and engineering related payroll expenses from April 2009 through June 2010, the completion of this product development effort. Since July 2010, Cercacor has continued to assist us with other product development efforts and charged us accordingly. We expect this arrangement to continue in the future. During the three and nine months ended October 1, 2011, the total of these additional expenses were \$541,000 and \$1.9 million, respectively. For additional discussion of Cercacor, see Note 4 to the condensed consolidated financial statements.

For the foreseeable future, we anticipate that we will continue to consolidate Cercacor pursuant to the current authoritative accounting guidance; however, in the event that Cercacor is no longer considered a variable interest entity, or VIE, or in the event that we are no longer the primary beneficiary of Cercacor, we may discontinue consolidating the entity.

**Table of Contents****SEDLine, Inc.**

During the six months ended July 3, 2010, SEDLine, Inc., or SEDLine, was considered to be a VIE and we were deemed to be the primary beneficiary. Therefore, we included SEDLine's revenue and expenses incurred during the six months ended July 3, 2010 in our condensed consolidated statement of income for the period. However, SEDLine was a noncontrolling interest of ours and therefore its net losses incurred during the six months ended July 3, 2010 were not included in the net income attributable to us.

On July 2, 2010, we acquired SEDLine and as a result, SEDLine became a wholly-owned subsidiary and was no longer a noncontrolling interest of ours. For the three months ended October 2, 2010, due to SEDLine's change in status, we included SEDLine's revenue, expenses and results thereof, in our condensed consolidated statement of income. For the three and nine months ended October 1, 2011, we continued to include SEDLine's revenue, expenses and results thereof in our condensed consolidated statements of income. As of October 1, 2011 and January 1, 2011, since SEDLine was a wholly-owned subsidiary, all of SEDLine's assets, liabilities and equity were consolidated with us. For additional discussion of SEDLine, see Note 4 to the condensed consolidated financial statements.

**Results of Operations**

The following table sets forth, for the periods indicated, our unaudited results of operations expressed as dollar amounts and as a percentage of total revenues (in thousands, except percentages).

	October 1, 2011	Three Months Ended % of Revenue	October 2, 2010	% of Revenue	October 1, 2011	Nine Months Ended % of Revenue	October 2, 2010	% of Revenue
<b>Revenue:</b>								
Product	\$ 97,639	93.8%	\$ 88,823	88.0%	\$ 301,771	92.4%	\$ 262,647	87.6%
Royalty	6,401	6.2	12,165	12.0	24,876	7.6	37,186	12.4
Total revenue	104,040	100.0	100,988	100.0	326,647	100.0	299,833	100.0
Cost of goods sold	35,601	34.2	29,376	29.1	106,125	32.5	88,379	29.5
Gross profit	68,439	65.8	71,612	70.9	220,522	67.5	211,454	70.5
<b>Operating expenses:</b>								
Selling, general and administrative	40,134	38.6	39,547	39.2	125,275	38.4	129,862	43.3
Research and development	9,372	9.0	9,227	9.1	28,793	8.8	27,688	9.2
Antitrust litigation proceeds							(30,728)	(10.2)
Total operating expenses	49,506	47.6	48,774	48.3	154,068	47.2	126,822	42.3
Operating income	18,933	18.2	22,838	22.6	66,454	20.3	84,632	28.2
Non-operating income (expense)	(240)	(0.2)	1,232	1.2	482	0.1	1,194	0.4
Income before provision for income taxes	18,693	18.0	24,070	23.8	66,936	20.5	85,826	28.6
Provision for income taxes	3,869	3.7	7,376	7.3	17,049	5.2	29,052	9.7
Net income including noncontrolling interests	14,824	14.3	16,694	16.5	49,887	15.3	56,774	18.9
Net (income) loss attributable to the noncontrolling interests	5	0.0	(275)	(0.3)	(7)	(0.0)	642	0.2
Net income attributable to Masimo Corporation	\$ 14,829	14.3%	\$ 16,419	16.3%	\$ 49,880	15.3%	\$ 57,416	19.1%

**Comparison of the Three Months Ended October 1, 2011 to the Three Months Ended October 2, 2010**

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*Revenue.* Total revenue increased \$3.0 million, or 3.0%, to \$104.0 million for the three months ended October 1, 2011 from \$101.0 million for the three months ended October 2, 2010.

Product revenues increased \$8.8 million, or 9.9%, to \$97.6 million in the three months ended October 1, 2011 from \$88.8 million in the three months ended October 2, 2010. This increase was primarily due to higher consumable sales resulting from an increase in our installed base of circuit boards and pulse oximeters which we estimate totaled 950,000 units at October 1, 2011, up from 821,000 units at October 2, 2010. This increase was partially offset by a decrease of \$4.1 million in rainbow<sup>®</sup> technology product revenues, which declined to \$7.8 million in the three months ended October 1, 2011 from \$11.9 million, which included an approximately \$4.0 million rainbow<sup>®</sup> order from the U.S. Marine Corp, in the three months ended October 2, 2010.



## **Table of Contents**

Revenue generated through our direct and distribution sales channels increased \$12.5 million, or 17.9%, to \$82.6 million for the three months ended October 1, 2011 compared to \$70.1 million for the three months ended October 2, 2010. During the three months ended October 1, 2011, revenues from our OEM channel decreased \$3.7 million, or 19.8%, to \$15.0 million from \$18.7 million in the three months ended October 2, 2010.

Our royalty revenue decreased \$5.8 million to \$6.4 million in the three months ended October 1, 2011 from \$12.2 million in the three months ended October 2, 2010. This reduction in revenue was due to a reduction in the royalty rate from 13.0% to 7.75% of Covidien's U.S. pulse oximetry sales, which became effective on March 15, 2011. This rate reduction was the result of a second amendment to the original settlement agreement with Covidien, which we entered into on January 28, 2011. For additional discussion of the second amendment, see Note 7 to the condensed consolidated financial statements.

*Cost of Goods Sold.* Cost of goods sold increased \$6.2 million to \$35.6 million in the three months ended October 1, 2011 from \$29.4 million in the three months ended October 2, 2010. Our total gross margin decreased to 65.8% for the three months ended October 1, 2011 from 70.9% for the three months ended October 2, 2010. Excluding royalties, product gross margin decreased by 3.4% to 63.5% for the three months ended October 1, 2011 from 66.9% for the three months ended October 2, 2010. This decrease was primarily due to selected inventory charge-offs related to product redesign and transition activities, increased amortization costs associated with increased equipment placed at hospitals and unfavorable product mix due primarily to decreased sales of rainbow® related products. We incurred \$1.3 million in Cercacor royalty expenses for both the three months ended October 1, 2011 and October 2, 2010, which have been eliminated in our condensed consolidated financial results for the periods presented. Had these royalty expenses not been eliminated, our reported product gross profit margin would have been 62.3% and 65.5% for the three months ended October 1, 2011 and October 2, 2010, respectively.

*Selling, General and Administrative.* Selling, general and administrative expenses increased \$587,000, or 1.5%, to \$40.1 million for the three months ended October 1, 2011 from \$39.5 million for the three months ended October 2, 2010. This increase was primarily due to a \$2.7 million increase in payroll and related costs, primarily due to increased staffing levels, as well as increased sales related commissions. This increase was offset by a decrease of \$706,000 in legal fees as a result of a reduction in litigation activity, and \$703,000 in various one-time grants and marketing initiatives incurred during the three months ended October 2, 2010. Included in total selling, general and administrative expenses are \$486,000 and \$466,000 of direct expenses incurred by Cercacor for the three months ended October 1, 2011 and October 2, 2010, respectively.

*Research and Development.* Research and development expenses increased \$145,000, or 1.6%, to \$9.4 million for the three months ended October 1, 2011 from \$9.2 million for the three months ended October 2, 2010. The increase was primarily due to increased new project costs and engineering supplies related to new product development. Included in total research and development expenses are \$947,000 and \$572,000 of engineering expenses incurred by our VIEs for the three months ended October 1, 2011 and October 2, 2010, respectively.

*Non-operating income (expense).* Non-operating expense was \$240,000 for the three months ended October 1, 2011, as compared to income of \$1.2 million for the three months ended October 2, 2010. This change of \$1.5 million was primarily due to the recognition of realized and unrealized losses on foreign currency denominated transactions during the three months ended October 1, 2011, as compared to the recognition of realized and unrealized gains on foreign currency denominated transactions during the three months ended October 2, 2010. The realized and unrealized losses on foreign currency recognized during the three months ended October 1, 2011 resulted primarily from the strengthening of the U.S. dollar against the Euro and Australian dollar partially offset by the weakening of the U.S. dollar against the Japanese yen. The realized and unrealized gains recognized during the three months ended October 2, 2010 resulted primarily from the weakening of the U.S. dollar against the Euro and the Japanese yen.

*Provision for Income Taxes.* Our provision for income taxes was \$3.9 million for the three months ended October 1, 2011 compared to \$7.4 million for the three months ended October 2, 2010. Our effective tax rate decreased to 20.7% for the three months ended October 1, 2011, compared to 30.6% for the three months ended October 2, 2010. This decrease in the effective tax rate was due primarily to the extension of the federal research and experiment credit, the change in the state effective tax rate and the mix of income in jurisdictions in which we do business. Our future effective income tax rate will depend on various factors, including profits (losses) before taxes, changes to tax law, the recognition and derecognition of tax benefits associated with uncertain tax positions and the geographic composition of pre-tax income.

### ***Comparison of the Nine Months Ended October 1, 2011 to the Nine Months Ended October 2, 2010***

*Revenue.* Total revenue increased \$26.8 million, or 8.9%, to \$326.6 million for the nine months ended October 1, 2011 from \$299.8 million for the nine months ended October 2, 2010.

Product revenues increased \$39.2 million, or 14.9%, to \$301.8 million in the nine months ended October 1, 2011 from \$262.6 million in the nine months ended October 2, 2010. This increase was primarily due to higher consumable sales resulting from



**Table of Contents**

an increase in our installed base of circuit boards and pulse oximeters which we estimate totaled 950,000 units at October 1, 2011, up from 821,000 units at October 2, 2010. Revenue generated through our direct and distribution sales channels increased \$46.5 million, or 22.5%, to \$252.7 million for the nine months ended October 1, 2011 compared to \$206.2 million for the nine months ended October 2, 2010. During the nine months ended October 1, 2011, revenues from our OEM channel decreased \$7.3 million, or 12.9%, to \$49.1 million from \$56.4 million in the nine months ended October 2, 2010.

Our royalty revenue decreased \$12.3 million to \$24.9 million in the nine months ended October 1, 2011 from \$37.2 million in the nine months ended October 2, 2010. This reduction in revenue was due to a reduction in the royalty rate from 13.0% to 7.75% of Covidien's U.S. pulse oximetry sales, which became effective on March 15, 2011. This rate reduction was the result of a second amendment to the original settlement agreement with Covidien, which we entered into on January 28, 2011. For additional discussion of the second amendment, see Note 7 to the condensed consolidated financial statements.

*Cost of Goods Sold.* Cost of goods sold increased \$17.7 million to \$106.1 million in the nine months ended October 1, 2011 from \$88.4 million in the nine months ended October 2, 2010. Our total gross margin decreased to 67.5% for the nine months ended October 1, 2011 from 70.5% for the nine months ended October 2, 2010. Excluding royalties, product gross margin decreased by 1.6% to 64.8% for the nine months ended October 1, 2011 from 66.4% for the nine months ended October 2, 2010. This decrease was primarily due to increased amortization costs associated with increased equipment placed at hospitals and selected inventory charge-offs related to product redesign and transition activities. We incurred \$3.8 million in Cercacor royalty expenses for both the nine months ended October 1, 2011 and October 2, 2010, which have been eliminated in our condensed consolidated financial results for the periods presented. Had these royalty expenses not been eliminated, our reported product gross profit margin would have been 63.6% and 64.9% for the nine months ended October 1, 2011 and October 2, 2010, respectively.

*Selling, General and Administrative.* Selling, general and administrative expenses decreased \$4.6 million, or 3.5%, to \$125.3 million for the nine months ended October 1, 2011 from \$129.9 million for the nine months ended October 2, 2010. The decrease was primarily due to \$13.0 million of one-time expenses, incurred during the nine months ended October 2, 2010, comprised of a \$10.3 million contribution to establish the Masimo Foundation and \$2.7 million in various one-time grants and marketing initiatives related to our plans to reinvest a portion of the antitrust settlement payment we received in January 2010. Excluding these various one-time expenses, selling, general and administrative expenses increased \$8.4 million, for the nine months ended October 1, 2011 as compared to the nine months ended October 2, 2010. This increase was primarily due to a \$6.8 million increase in payroll and related costs and a \$1.6 million increase in travel related expenses, both associated with increased staffing levels. In addition, expenses related to legal fees increased by \$2.3 million, due to additional litigation activity during the nine months ended October 1, 2011. These increases in expense were offset by a decrease of \$1.8 million in sample related expenses and a decrease of \$804,000 in training and other miscellaneous related expenses. Included in total selling, general and administrative expenses are \$1.4 million and \$1.7 million of direct expenses incurred by our VIEs for the nine months ended October 1, 2011 and October 2, 2010, respectively.

*Research and Development.* Research and development expenses increased \$1.1 million, or 4.0%, to \$28.8 million for the nine months ended October 1, 2011 from \$27.7 million for the nine months ended October 2, 2010. The increase was primarily due to increased payroll and payroll related costs of \$633,000 associated with increased staffing levels. In addition, depreciation increased by \$207,000 due to additional capital equipment purchased to support the growth of our business. Included in total research and development expenses are \$2.5 million and \$2.0 million of engineering expenses incurred by our VIEs for the nine months ended October 1, 2011 and October 2, 2010, respectively.

*Antitrust litigation proceeds.* Antitrust litigation proceeds were \$0 for the nine months ended October 1, 2011, as compared to proceeds of \$30.7 million for the nine months ended October 2, 2010, due to the settlement of the antitrust litigation with Covidien in January 2010. This settlement followed the Ninth Circuit Court of Appeals' October 2009 affirmation of a Federal District Court decision that Tyco Healthcare, now Covidien, violated the antitrust laws through anticompetitive business practices related to the sale of its pulse oximetry products.

*Non-operating income (expense).* Non-operating income was \$482,000 for the nine months ended October 1, 2011, as compared to \$1.2 million for the nine months ended October 2, 2010. This decrease of \$712,000 was primarily due to the decrease in the amount of realized and unrealized gains on foreign currency denominated transactions recognized during the nine months ended October 1, 2011, as compared to the amount of realized and unrealized gains on foreign currency denominated transactions recognized during the nine months ended October 2, 2010. The realized and unrealized gains on foreign currency denominated transactions recognized during the nine months ended October 1, 2011 resulted primarily from the weakening of the U.S. dollar against the Japanese yen, partially offset by the strengthening of the U.S. dollar against the Euro and Australian Dollar. The realized and unrealized gains on foreign currency denominated transactions recognized during the nine months ended October 2, 2010 resulted primarily from the weakening of the U.S. dollar against the Japanese yen, partially offset by the strengthening of the U.S. dollar against the Euro.



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**Table of Contents**

*Provision for Income Taxes.* Our provision for income taxes was \$17.0 million for the nine months ended October 1, 2011 compared to \$29.1 million for the nine months ended October 2, 2010. Our effective tax rate decreased to 25.5% for the nine months ended October 1, 2011, compared to 33.9% for the nine months ended October 2, 2010. This decrease in the effective tax rate was due primarily to the extension of the federal research and experiment credit, the change in the state effective tax rate and the mix of income in jurisdictions in which we do business. Our future effective income tax rate will depend on various factors, including profits (losses) before taxes, changes to tax law, the recognition and derecognition of tax benefits associated with uncertain tax positions and the geographic composition of pre-tax income.

***Liquidity and Capital Resources***

As of October 1, 2011, we had total cash and cash equivalents of \$143.2 million, of which \$96.0 million was invested in U.S. Treasury bills, \$1.4 million was in money market accounts with major financial institutions and \$45.8 million was in checking and savings accounts. We carry cash and cash equivalents at cost which approximates fair value.

During the three months ended October 1, 2011, we received \$6.9 million from Covidien for royalties related to their U.S. pulse oximetry sales. We expect to continue to receive a royalty based on Covidien's pulse oximetry products sales in the U.S., through the term of the royalty agreement and at least through March 15, 2014. The royalty rate was 13% through March 14, 2011, and as part of the second amendment to the original settlement agreement with Covidien, declined to 7.75% beginning March 15, 2011.

In August 2011, our board of directors authorized us to repurchase up to 3,000,000 shares of our common stock under a repurchase program. During the three months ended October 1, 2011, no shares were repurchased. We expect to pay for any future repurchases of stock with available cash and cash equivalents. The repurchase program is expected to continue until August 2013 unless it is terminated earlier by our board of directors.

*Cash Flows from Operating Activities.* Cash provided by operating activities was \$54.1 million in the nine months ended October 1, 2011. The source of cash consists primarily of net income including noncontrolling interests of \$49.9 million due to continued growth of our business and a decrease in royalties receivable of \$5.3 million due to the decline in the royalty rate. Additionally, non-cash activity for share-based compensation and depreciation and amortization were \$10.2 million and \$5.6 million, respectively. These sources of cash were partially offset by an increase in prepaid expenses of \$5.5 million due to the prepayment of income taxes and an increase in deferred cost of goods sold of \$4.3 million due to continued shipments of equipment to customers pursuant to long-term sensor contracts. Additional offsets to the sources of cash were an increase in accounts receivable of \$4.0 million due to both timing of collections and growth of our business, a decrease in accrued compensation of \$2.7 million primarily as a result of 2010 annual bonus payouts in the first quarter of 2011, and an increase in inventory of \$2.4 million to meet the anticipated future demand for our products.

Cash provided by operating activities was \$53.8 million in the nine months ended October 2, 2010. The source of cash consists primarily of net income including noncontrolling interests of \$56.8 million, non-cash share-based compensation of \$8.9 million, an increase in accounts payable of \$7.2 million due to continued growth of our business and inventory purchases in anticipation of future demand for our products, and depreciation and amortization expense of \$4.8 million. These sources of cash were partially offset by an increase in inventory of \$12.3 million to meet the anticipated future demand for our products for both the sale and placement at hospitals under our long-term sensor agreements, an increase in accounts receivable of \$10.6 million due to both timing of collections and growth of our business, and an increase in deferred cost of goods sold of \$7.2 million as a result of continued shipments of equipment to customers pursuant to long-term sensor agreements.

*Cash Flows from Investing Activities.* Cash used in investing activities for the nine months ended October 1, 2011 was \$5.2 million, consisting of \$3.5 million for purchases of property and equipment to support our manufacturing operations and \$1.7 million for the increase in intangible assets related to capitalized patent costs. Cash provided by investing activities for the nine months ended October 2, 2010 was \$49.7 million consisting of sales and maturities of short-term investments of \$133.0 million, offset by purchases of short-term investments of \$76.0 million, due to our investment strategy of preserving capital while obtaining higher interest rates. Additionally, we used \$5.9 million of cash to purchase property and equipment to support our manufacturing operations.

*Cash Flows from Financing Activities.* Cash provided by financing activities for the nine months ended October 1, 2011 was \$5.6 million, primarily due to \$5.6 million of proceeds from the issuance of common stock associated with the exercise of stock options. Cash used in financing activities for the nine months ended October 2, 2010 was \$110.8 million, primarily due to \$117.5 million of dividend payments, offset by \$6.3 million of proceeds from the issuance of common stock associated with the exercise of stock options.

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## **Table of Contents**

*Future Liquidity Needs.* In the future, in addition to funding our working capital requirements, we anticipate our primary use of cash to be the equipment that we provide to hospitals under our long-term sensor purchase agreements. We anticipate additional capital purchases related to expanding our worldwide international operations including manufacturing, sales, marketing and other areas of necessary infrastructure growth. Our focus on international expansion will also require both continuing and incremental investments in facilities and infrastructure in the Americas, Europe and Asia. We also anticipate possible uses of cash for the acquisition of technologies or the acquisition of technology companies. The amount and timing of our actual investing activities will vary significantly depending on numerous factors, such as the progress of our product development efforts, our timetable for international sales operations and manufacturing expansion and both domestic and international regulatory requirements. Additionally, we expect to pay for any future repurchases of our common stock with available cash and cash equivalents. Despite these capital investment requirements, we anticipate that our existing cash and cash equivalents will be sufficient to meet our working capital requirements, capital expenditures and operations for at least the next 12 months.

### ***Off-Balance Sheet Arrangements***

We do not currently have, nor have we ever had, any relationships with unconsolidated entities or financial partnerships, such as entities referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts. As a result, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we engaged in these relationships.

### ***Critical Accounting Policies and Estimates***

The discussion and analysis of our financial condition and results of operations is based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these condensed consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements, as well as revenue and expenses during the reporting periods. Significant estimates include: determination of accounts receivable allowances, inventory reserves, warranty reserves, rebate reserves, valuation of our stock options, distributor channel inventory, royalty revenues, deferred revenue, uncertain income tax positions and property taxes. We evaluate our estimates and judgments on an ongoing basis. We base our estimates on historical experience and on various other factors we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results therefore could differ materially from those estimates under different assumptions or conditions.

For a description of our critical accounting policies and estimates, please refer to the *Critical Accounting Estimates* section of the *Management's Discussion and Analysis of Financial Condition and Results of Operations* section contained in our Annual Report on Form 10-K for the fiscal year ended January 1, 2011 filed with the SEC on February 16, 2011. There have been no material changes in our critical accounting policies since January 1, 2011, except for our revenue recognition policy described below and in Note 2 to the condensed consolidated financial statements, which was effective beginning on January 2, 2011.

### ***Revenue Recognition***

We follow the current authoritative guidance for revenue recognition. Based on these requirements, we recognize revenue when: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the price is fixed or determinable, and (iv) collectability is reasonably assured. We enter into agreements to sell pulse oximetry and related products and services as well as multiple deliverable arrangements that include various combinations of products and services. While the majority of our sales transactions contain standard business terms and conditions, there are some transactions that contain non-standard business terms and conditions. As a result, contract interpretation is sometimes required to determine the appropriate accounting, including: (a) whether an arrangement exists, (b) how the arrangement consideration should be allocated among the deliverables if there are multiple deliverables, (c) when to recognize revenue on the deliverables, and (d) whether undelivered elements are essential to the functionality of the delivered elements. Changes in judgments on these assumptions and estimates could materially impact the timing of revenue recognition.

In September 2009, the Financial Accounting Standards Board, or FASB, amended the accounting standards related to revenue recognition for arrangements with multiple deliverables. The new standard changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable to be based on relative selling prices. The FASB also amended the accounting standards for revenue recognition to exclude software that is contained in a tangible product from the scope of software revenue guidance if the



## **Table of Contents**

software is essential to the tangible product's functionality. We adopted these new standards on a prospective basis. Therefore, the new standards apply only to revenue arrangements entered into or materially modified beginning January 2, 2011. For revenue arrangements that were entered into or materially modified after the adoption of these standards, implementation of this new authoritative guidance had no significant impact on our reported revenue during either the three or nine months ended October 1, 2011 as compared to revenue if the related arrangements entered into or materially modified after January 2, 2011 were subject to the accounting requirements in effect in the prior year.

The new standards establish a hierarchy to determine the selling price to be used for allocating revenue to deliverables as follows:

(i) vendor-specific objective evidence of fair value, or VSOE, (ii) third-party evidence of selling price, or TPE, and (iii) best estimate of the selling price, or ESP. VSOE is defined as the price charged when the same element is sold separately. VSOE generally exists only when the deliverable is sold separately and is the price actually charged for that deliverable. TPE generally does not exist for the majority of our products because of their uniqueness. The objective of ESP is to determine the price at which we would transact a sale if the product was sold on a stand-alone basis. In the absence of VSOE and TPE, we determine ESP for our products by considering multiple factors including, but not limited to, features and functionality of the product, geographies, type of customer, contractual prices pursuant to Group Purchasing Organization, or GPO, contracts, our pricing and discount practices and market conditions.

A deliverable in an arrangement qualifies as a separate unit of accounting if the delivered item has value to the customer on a stand-alone basis. Most of our products in a multiple deliverable arrangement qualify as separate units of accounting. In the case of our monitoring equipment products containing embedded Masimo SET software, we have determined that the hardware and software components function together to deliver the product's essential functionality, and therefore, represent a single deliverable. In accordance with the new guidance, the revenue from the sale of these products no longer falls within the scope of the software revenue recognition guidance. Software deliverables, such as rainbow<sup>®</sup> parameter software, which do not function together with hardware components to provide the product's essential functionality, continue to be accounted for under software revenue recognition guidance. Our multiple deliverable arrangements may therefore have software deliverables that are subject to the existing software revenue recognition guidance. The revenue for these multiple-element arrangements is allocated to the software deliverables and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy in the new revenue recognition accounting guidance for arrangements with multiple deliverables.

Our sales under long-term sensor purchase contracts are generally structured such that we agree to provide up-front and at no initial charge certain monitoring equipment, software, installation, training and ongoing warranty support in exchange for the hospital's agreement to purchase sensors over the term of the agreement, which ranges from three to six years. The sensors are essential to the functionality of the monitoring equipment and, therefore, represent a substantive performance obligation. We do not recognize any revenue when the monitoring and related equipment and software is delivered to the hospitals and installation and training is complete. We recognize revenue for these delivered elements, on a pro-rata basis, as the sensors are delivered under the long-term purchase commitment. The adoption of the new guidance for revenue recognition did not change this pattern of revenue recognition for long-term sensor purchase contracts. The cost of the monitoring equipment initially placed at the hospitals is deferred and amortized to cost of goods sold over the life of the underlying long-term sensor purchase contract.

To the extent that the allocation of revenue to multiple deliverables under long-term sensor agreements depends on our estimated selling prices, there is uncertainty over the percentage allocation to equipment, sensors and software. A change in the factors we use to estimate selling price, the weighting we assign to different factors, or a change in our pricing and discounting strategy could result in a different allocation to the deliverables in an arrangement. However, because we recognize revenue as sensors are delivered over the term of the agreement, the total revenue recognized under long-term sensor agreements in any period is not dependent on the allocation to the deliverables. The total amount of revenue recognized under long-term sensor agreements in a period is dependent on the amount of sensors shipped in the period. Our long-term sensor agreements provide for a minimum annual purchase commitment by our customers, but the timing and amount of customer purchases may vary from period to period.

### ***New Accounting Pronouncements***

In May 2011, the FASB issued Accounting Standards Update No. 2011-04, or ASU 11-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU 11-04 provides a consistent definition of fair value and ensures that the fair value measurement and disclosure requirements are similar between U.S. GAAP and International Financial Reporting Standards. ASU 11-04 changes certain fair value measurement principles and enhances the disclosure requirements particularly for level 3 fair value measurements. This update is effective for interim and annual periods beginning after December 15, 2011 and should be applied prospectively. We do not expect the adoption of this update to have a material impact on our condensed consolidated financial statements.





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**Table of Contents**

In June 2011, the FASB issued Accounting Standards Update No. 2011-05, or ASU 11-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. ASU 11-05 requires us to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 11-05 eliminates the option to present the components of other comprehensive income as part of the statement of equity. ASU 11-05 is effective for interim and annual periods beginning after December 15, 2011, and should be applied retrospectively. Early adoption of this update is permitted. We do not expect the adoption of this update to have a material impact on our condensed consolidated financial statements, as it only requires a change in the format of presentation.

In September 2011, the FASB issued Accounting Standards Update No. 2011-08, or ASU 11-08, *Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment*, to allow us to use a qualitative approach to test goodwill for impairment. ASU 11-08 permits us to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed two-step goodwill impairment test. Otherwise, the two-step goodwill impairment test is not required. ASU 11-08 is effective for interim and annual periods beginning after December 15, 2011. Early adoption of this update is permitted. We do not expect the adoption of this update to have a material impact on our condensed consolidated financial statements.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk represents the risk of changes in the value of market risk sensitive instruments caused by fluctuations in interest rates, foreign exchange rates and commodity prices. We are exposed to various market risks that may arise from adverse changes in market rates and prices, such as interest rates, foreign exchange fluctuations and inflation. We do not enter into derivatives or other financial instruments for trading or speculative purposes.

***Interest Rate Risk***

Our exposure to market risk for changes in interest rates relates to the increase or decrease in the amount of interest income we can earn on our investment portfolio and on the increase or decrease in the amount of interest expense we must pay with respect to our outstanding debt instruments. Our risk associated with fluctuation in interest expense is limited to our outstanding capital lease arrangements, which have fixed interest rates. Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes. We ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We reduce default risk by investing in investment grade securities. Our investment portfolio consists of highly liquid investments with an original maturity from the date of purchase of three months or less, that have historically been held to maturity. Therefore, a hypothetical 100 basis point change in interest rates along the entire interest rate yield curve would not significantly affect the fair value of our interest-sensitive financial instruments at October 1, 2011. Declines in interest rates over time will, however, reduce our interest income and expense while increases in interest rates will increase our interest income and expense.

***Foreign Currency Exchange Rate Risk***

A majority of our assets and liabilities are maintained in the United States in U.S. dollars and a majority of our sales and expenditures are transacted in U.S. dollars. We transact with foreign customers in currencies other than the U.S. dollar. These foreign currency revenues, when converted into U.S. dollars, can vary depending on average exchange rates during a respective period. In addition, we are exposed to foreign currency gains or losses on outstanding foreign currency denominated receivables. Realized and unrealized foreign currency gains or losses on these transactions are included in our statements of income as incurred. Certain of our foreign sales support subsidiaries transact in their respective country's local currency, which is also their functional currency. As a result, expenses of these foreign subsidiaries when converted into U.S. dollars can vary depending on average monthly exchange rates during a respective period. Certain intercompany transactions may give rise to realized and unrealized foreign currency gains or losses. These foreign currency gains or losses are included in our statements of income as incurred. In addition, any other transactions between us or our subsidiaries and a third party, denominated in a currency different from the functional currency, are a foreign currency transaction. Realized and unrealized foreign currency gains or losses on these transactions are included in our statements of income as incurred and are converted to U.S. dollars at average exchange rates for a respective period.

The balance sheets of our foreign subsidiaries whose functional currency is not the U.S. dollar are translated into U.S. dollars at the rate of exchange at the balance sheet date and the statements of income and cash flows are translated into U.S. dollars using the average monthly exchange rate during the period. Any foreign exchange gain or loss as a result of translating the balance sheets of our foreign subsidiaries whose functional currency is not the U.S. dollar is included in equity as a component of accumulated other comprehensive income.



## **Table of Contents**

Our primary foreign currency exchange rate exposures are with the Euro, the Japanese yen, the Canadian dollar, the British pound and the Australian dollar against the U.S. dollar. Foreign currency exchange rates have experienced significant movements and may continue to do so in the future. We currently do not enter into forward exchange contracts to hedge exposures denominated in foreign currencies and do not use derivative financial instruments for trading or speculative purposes. The effect of a 10% change in foreign currency exchange rates could have a material effect on our future operating results or cash flows, depending on which foreign currency exchange rates change and depending on the directional change (either a strengthening or weakening against the U.S. dollar). As our foreign operations continue to grow, our exposure to foreign currency exchange rate risk may become more significant.

### ***Inflation Risk***

We do not believe that inflation has had a material effect on our business, financial condition or results of operations during the periods presented. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could have a material adverse effect on our business, financial condition and results of operations.

### **Item 4. Controls and Procedures**

#### ***Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures***

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended, or the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's regulations, 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 Rule 13a-15(b) promulgated by the SEC under the Exchange Act, 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 Quarterly Report on Form 10-Q. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

#### ***Changes in Internal Control Over Financial Reporting***

There has been no change in our internal control over financial reporting during the quarter ended October 1, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

On February 3, 2009, we filed a patent infringement suit against Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH related to Philips FAST pulse oximetry technology and certain of Philips patient monitors. The suit was brought in the U.S. District Court for the District of Delaware. Two patents originally asserted in this suit, related to our measure-through motion technology, were successfully enforced in our previous suit against Nellcor. On June 15, 2009, Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH answered our complaint and Philips Electronics North America Corporation filed antitrust and patent infringement counterclaims against us as well as counterclaims seeking declaratory judgments of invalidity on the patents asserted by us against Philips. On July 9, 2009, we filed our answer denying Philips counterclaims and asserting various defenses. We also asserted counterclaims against Philips for fraud, intentional interference with prospective economic advantage and for declaratory judgments of noninfringement and invalidity with respect to the patents asserted by Philips against us. Philips later added a claim for infringement of one additional patent. Subsequently, the Court bifurcated Philips antitrust claims and its patent misuse defense, as well as stayed the discovery phase on those claims pending trial in the patent case. On October 4, 2010, the Court limited the number of patents to be construed to four for us and three for Philips. In addition, on October 6, 2010, the Court denied Philips motion to bifurcate and stay damages in the patent case. In December 2010, the Court held a hearing regarding the construction of the patent claims and the Magistrate Judge issued a Report and Recommendation on claim construction on February 18, 2011. The parties are awaiting the claim construction order from the District Court Judge. We believe that we have good and substantial defenses to the antitrust and patent infringement claims asserted by Philips. There is no guarantee that we will prevail in this suit or receive any damages or other relief if we do prevail.

From time to time, we are involved in legal proceedings in the ordinary course of business. Other than the proceeding described above, we are not currently involved in any material legal proceedings.

**ITEM 1A. RISK FACTORS**

*Before you decide to invest or maintain an interest in our common stock, you should consider carefully the risks described below, which have been updated since the filing of our Annual Report on Form 10-K with the SEC on February 16, 2011, together with the other information contained in this Quarterly Report on Form 10-Q. We believe the risks described below are the risks that are material to us as of the date this Quarterly Report on Form 10-Q is initially filed with the SEC. If any of the following risks comes to fruition, our business, financial condition, results of operations and growth prospects would likely be materially and adversely affected. In these circumstances, the market price of our common stock could decline, and you could lose all or part of your investment or interest.*

*We have marked with an asterisk (\*) those risk factors below that include a substantive change from or update to the risk factors included in our Annual Report on Form 10-K filed with the SEC on February 16, 2011.*

**Risks Related to Our Revenues**

**We currently derive substantially all of our revenue from our Masimo SET platform, Masimo rainbow® SET platform and related products. If this technology and the related products do not continue to achieve market acceptance, our business, financial condition and results of operations would be adversely affected.**

We are dependent upon the success and market acceptance of our proprietary Masimo SET. Currently, our primary product offerings are based on the Masimo SET platform. Continued market acceptance of products incorporating Masimo SET will depend upon our ability to continue to provide evidence to the medical community that our products are cost-effective and offer significantly improved performance compared to conventional pulse oximeters. Health care providers that currently have significant investments in competitive pulse oximetry products may be reluctant to purchase our products. If hospitals and other health care providers do not believe our Masimo SET platform is cost-effective, safe or more accurate or reliable than competitive pulse oximetry products, they may not buy our products in sufficient quantities to enable us to be profitable. In addition, allegations regarding the safety and effectiveness of our products, whether or not substantiated, may impair or impede the acceptance of our products. If we are unable to achieve additional market acceptance of our core technology or products incorporating Masimo SET, we will not generate significant revenue growth from the sale of our products.



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**Table of Contents**

**Some of our products, including those based on licensed rainbow<sup>®</sup> technology, are in development or have been recently introduced into the market and may not achieve market acceptance, which could limit our growth and adversely affect our business, financial condition and results of operations.**

Our products that have been recently introduced into the market, including, but not limited to, those based on rainbow<sup>®</sup> technology, a technology that we license, may not be accepted in the market. In September 2008, we began our limited market release of total hemoglobin, and focused on obtaining data and clinical feedback on the performance of the product in the hospital. In October 2008, we received FDA clearance for Pronto, a handheld noninvasive multi-parameter testing device, not a continuous monitoring device, that uses our rainbow<sup>®</sup> SET technology, to provide pulse oximetry, pulse rate, perfusion index and spot-checking of total hemoglobin levels. In the first quarter of 2009, we commercially launched our total hemoglobin product for continuous and noninvasive monitoring in the hospital. In June 2010, we received FDA clearance for Pronto-7, a handheld noninvasive multi-parameter testing device, that provides spot-check hemoglobin testing along with oxygen saturation, pulse rate and perfusion index results. This device is used for, among other things, spot-check testing of hemoglobin in almost any environment. Also, in June 2010, we initiated a full commercial release of rainbow Acoustic Monitoring<sup>™</sup> after a limited market release that allowed us to evaluate the product's performance in the field.

Given that certain rainbow<sup>®</sup> technology products are new to the marketplace, we do not know to what degree the market will accept these products, if at all. Even if our customers recognize the benefits of our products, we cannot assure you that our customers will purchase them in quantities sufficient for us to be profitable or successful. We will need to invest in significant sales and marketing resources to achieve market acceptance of these products with no assurance of success. The degree of market acceptance of these products will depend on a number of factors, including:

perceived advantages of our products and their sales prices;

perceived safety and effectiveness of our products;

reimbursement available through Centers for Medicare and Medicaid Services, or CMS, programs for using our products; and

introduction and acceptance of competing products or technologies.

In general, all of our new noninvasive technologies are new technologies. These new technologies have performance levels that we believe are acceptable for many clinical environments but may be insufficient in others. In addition, these noninvasive technologies may perform better in some patients and settings than others. The performance of these technologies shows a variability across a population that follows a gaussian distribution described in the accuracy specifications. Over time, we hope to reduce this variability and, if we do, we expect these new noninvasive technologies to become more useful in additional environments and to become more widely adopted. This is the adoption pattern we have experienced historically with our previously released measurements, such as oxygen saturation, and what we expect to experience in the future with our current and future technologies. Although we will seek to reduce this variability over time, we may not be successful. If our products do not gain market acceptance or if our customers prefer our competitors' products, our potential growth would be limited, which would adversely affect our business, financial condition and results of operations.

In addition, in December 2010, we announced our determination to voluntarily recall our Pronto-7 rainbow<sup>®</sup> 4D spot-check reusable sensors, which were in limited market release. The recall was initiated after we became aware that the thermistor on the sensor was not working as designed. As a result, we determined that the Pronto-7 multi-parameter spot-check device may have provided a SpHb measurement outside our specification range in certain settings. Although we are working to develop a replacement Pronto-7 rainbow<sup>®</sup> 4D sensor that will address the differences, there can be no assurance that we will be able to complete the development of a replacement sensor on a timely basis, that the replacement sensor will function properly in accordance with its design, or that the replacement sensor will achieve market acceptance. In the event of a prolonged delay in releasing a replacement Pronto-7 rainbow<sup>®</sup> 4D sensor, or if our replacement sensors receive limited market acceptance, our business, financial condition and results of operations could be adversely affected.

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**Table of Contents**

**Our ability to commercialize new products, new or improved technologies and additional applications for Masimo SET and our right to use rainbow® technology are each limited to certain markets by our Cross-Licensing Agreement with Cercacor, which may impair our growth and adversely affect our financial condition and results of operations.**

In May 1998, we spun off a newly-formed entity, Cercacor, and provided it rights to use Masimo SET to commercialize non-vital signs monitoring applications while we retained the rights to Masimo SET to commercialize vital signs monitoring applications. On May 2, 1998, we entered into a cross-licensing agreement with Cercacor, which has been amended several times, most recently in an Amended and Restated Cross-Licensing Agreement, effective January 1, 2007, or the Cross-Licensing Agreement. Under the Cross-Licensing Agreement, we granted Cercacor:

an exclusive, perpetual and worldwide license, with sublicense rights, to use all Masimo SET owned by us, including all improvements on this technology, for the monitoring of non-vital signs parameters and to develop and sell devices incorporating Masimo SET for monitoring non-vital signs parameters in any product market in which a product is intended to be used by a patient or pharmacist rather than by a professional medical caregiver, which we refer to as the Cercacor Market, and

a non-exclusive, perpetual and worldwide license, with sublicense rights, to use all Masimo SET for measurement of vital signs in the Cercacor Market.

Non-vital sign measurements consist of body fluid constituents other than vital sign measurements, including, but not limited to, carbon monoxide, methemoglobin, blood glucose, total hemoglobin and bilirubin.

Under the Cross-Licensing Agreement, we are only permitted to sell devices utilizing Masimo SET for the monitoring of non-vital signs parameters in markets where the product is intended to be used by a professional medical caregiver, including, but not limited to, hospital caregivers and alternate care market facility caregivers, rather than by a patient or pharmacist, which we refer to as the Masimo Market. Accordingly, our ability to commercialize new products, new or improved technologies and additional applications for Masimo SET is limited. In particular, our inability to expand beyond the Masimo Market may impair our growth and adversely affect our financial condition and results of operations.

Pursuant to the Cross-Licensing Agreement, we have licensed from Cercacor the right to make and distribute products in the Masimo Market that utilize rainbow® technology for the measurement of only carbon monoxide, methemoglobin, fractional arterial oxygen saturation and total hemoglobin, which includes hematocrit. As a result, the opportunity to expand the market for our products incorporating rainbow® technology is limited, which could limit our ability to maintain or increase our revenue and impair our growth.

**We face competition from other companies, many of which have substantially greater resources than we do. If we do not successfully develop and commercialize enhanced or new products that remain competitive with new products or alternative technologies developed by others, we could lose revenue opportunities and customers, and our ability to grow our business would be impaired.**

A number of our competitors have substantially greater capital resources, larger customer bases, larger sales forces than ours, and have established stronger reputations with target customers and built relationships with GPOs that are more effective than ours. We face substantial competition from companies developing products that compete with our Masimo SET platform for use with third-party monitoring systems. We also face competition from companies currently marketing pulse oximetry monitors.

The medical device industry is characterized by rapid product development and technological advances, which places our products at risk of obsolescence. Our long-term success depends upon the development and successful commercialization of new products, new or improved technologies and additional applications for Masimo SET and licensed rainbow® technology. The research and development process is time-consuming and costly and may not result in products or applications that we can successfully commercialize. In particular, we may not be able to successfully commercialize our products for applications other than arterial blood oxygen saturation and pulse rate monitoring, including acoustic respiration rate, hemoglobin, carboxyhemoglobin and methemoglobin monitoring. If we do not successfully adapt our products and applications both within and outside these measurements, we could lose revenue opportunities and customers. Furthermore, one or more of our competitors may develop products that are substantially equivalent to our FDA-cleared products, or those of our original equipment manufacturer, or OEM, partners, whereby they may be able to use our products or those of our OEM partners, as predicate devices to more quickly obtain FDA clearance of their competing products. Competition could result in reductions in the price of our products, fewer orders for our products, a reduction of our gross margins and a loss of our market share.





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**Table of Contents**

**We depend on our domestic and international OEM partners for a portion of our revenue. If they do not devote sufficient resources to the promotion of products that use Masimo SET and licensed rainbow® technology, our business would be harmed.**

We are, and will continue to be, dependent upon our domestic and international OEM partners for a portion of our revenue through their marketing, selling and distribution of certain of their products that incorporate Masimo SET and licensed rainbow® technology. Although we expect that our OEM partners will accept and actively market, sell and distribute products that incorporate licensed rainbow® technology, they may not elect, and they have no contractual obligation, to do so. Because products that incorporate our technologies may represent a relatively small percentage of business for some of our OEM partners, they may have less incentive to promote these products rather than other products that do not incorporate these technologies. In addition, some of our OEM partners offer products that compete with ours. Therefore, we cannot guarantee that our OEM partners, or any company that might acquire any of our OEM partners, will vigorously promote products incorporating Masimo SET and licensed rainbow® technology, or at all. The failure of our OEM partners to successfully market, sell or distribute products incorporating these technologies, the termination of OEM agreements, the loss of OEM partners or the inability to enter into future OEM partnership agreements would have a material adverse effect on our business, financial condition and results of operations.

**\* If we fail to maintain or develop relationships with GPOs, sales of our products would decline.**

Our ability to sell our products to U.S. hospitals depends, in part, on our relationships with GPOs. Many existing and potential customers for our products become members of GPOs. GPOs negotiate beneficial pricing arrangements and contracts, which are sometimes exclusive, with medical supply manufacturers and distributors.

These negotiated prices are made available to a GPO's affiliated hospitals and other members. If we are not one of the providers selected by a GPO, the GPO's affiliated hospitals and other members may be less likely or unlikely to purchase our products. If a GPO has negotiated a strict sole source, market share compliance or bundling contract for another manufacturer's products, we may be prohibited from making sales to members of the GPO for the duration of the contractual arrangement. For the three and nine months ended October 1, 2011, shipments of our pulse oximetry products to customers that are members of GPOs represented \$55.2 million and \$166.7 million, respectively, of our revenue from sales to U.S. hospitals. Our failure to renew our contracts with GPOs may cause us to lose market share and could have a material adverse effect on our sales, financial condition and results of operations. In addition, if we are unable to develop new relationships with GPOs, our competitive position would likely suffer and our business would be harmed.

**Inadequate levels of coverage or reimbursement from governmental or other third-party payers for our products, or for procedures using our products, may cause our revenue to decline.**

Sales of our products depend in part on the reimbursement and coverage policies of governmental and private health care payers. The ability of our health care provider customers, including hospitals, to obtain adequate coverage and reimbursement for our products, or for the procedures in which our products are used, may impact our customers' purchasing decisions. Therefore, our customers' inability to obtain adequate coverage and reimbursement for our products would have a material adverse effect on our business.

Third-party payers have adopted, and are continuing to adopt, health care policies intended to curb rising health care costs. These policies include, among others:

controls on reimbursement for health care services and price controls on medical products and services;

limitations on coverage and reimbursement for new medical technologies and procedures; and

the introduction of managed care and prospective payment systems in which health care providers contract to provide comprehensive health care for a fixed reimbursement amount per person or per procedure.

We cannot guarantee a governmental or third-party payer will reimburse, or continue to reimburse, a customer for the cost of our products. Some payers have indicated that they are not willing to reimburse for certain of our products or for the procedures in which our products are used. For example, some insurance carriers have issued policies denying coverage for transcutaneous hemoglobin measurement on the grounds that the technology is investigational in the outpatient setting. Other payers are continuing to investigate our products to determine if they will provide reimbursement to our customers. We are working with these payers to obtain reimbursement, but may not be successful. These trends could lead

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to pressure to reduce prices for our current products and product candidates and could cause a decrease in the size of the market or a potential increase in competition that could adversely affect our business, financial condition and results of operations.

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**Table of Contents**

**Our customers may reduce, delay or cancel purchases due to a variety of factors, such as lower hospital census levels or third-party guidelines, which could adversely affect our business, financial condition and results of operations.**

Our customers are facing a growing level of uncertainties, such as lower overall hospital census for paying patients and the impact of that lower census on hospital budgets.

In addition, there are specific portions of our business, such as our OEM customers, that, due to their capital equipment sales model, could be impacted by the ongoing economic uncertainties and the resulting constraints on hospital budgets. These hospital budget constraints could cause our OEMs more difficulty in selling their large, relatively high priced multi-parameter devices which, in turn, could reduce our board sales to our OEM customers. In addition, certain of our products, including our rainbow<sup>®</sup> measurements such as carbon monoxide, methemoglobin and total hemoglobin, are sold with upfront license fees and more complex, and therefore, more expensive sensors could be impacted by hospital budget reductions.

In addition, states and other local regulatory authorities may issue guidelines regarding the appropriate scope and use of our products from time to time. For example, our SpCO monitoring devices may be subject to authorization by individual states as part of Emergency Medical Services, or EMS, scope of practice procedures. The State of California recently categorized SpCO as a laboratory test and therefore outside the scope of practice for EMS providers. Although a lack of inclusion into scope of practice procedures does not prohibit usage, it may limit adoption.

**\* The loss of any large customer, or distributor, or any cancellation or delay of a significant purchase by a large customer could reduce our net sales and harm our operating results.**

We also have a concentration of OEM, distribution and direct customers. If for any reason we were to lose our ability to sell to a specific group or class of customers, or through a distributor, we would experience a significant reduction in revenue, which would adversely impact our operating results. Also, we cannot provide any assurance that we will retain our current customers or groups of customers, or distributors, or that we will be able to attract and retain additional customers in the future. For the three months ended October 1, 2011, we had sales through two just-in-time distributors, which each represented 14.3% and 9.9% of our total revenue, respectively. The loss of any large customer or distributor could have a material adverse effect on our financial condition and results of operations.

**Medical device reproprocessors that reprocess our single-use sensors and then resell them to hospitals at a cost lower than our new sensors may adversely affect our business, financial condition and results of operations.**

Certain medical device reproprocessors have been collecting our used single-use sensors from hospitals and then reprocessing, repackaging and reselling those sensors to hospitals at a price lower than our new sensors. These reprocessed sensors may lead to confusion with our authorized products, reduce our revenue and harm our customer relationships. In addition, this may increase time and expense spent investigating and addressing performance issues with the reprocessed sensors, and enforcing our proprietary rights and contracts against the reproprocessors.

Despite our agreements and our customers' acknowledged preference for disposable single patient adhesive sensors due to performance and risk of contamination, our customers that are concerned about finances could take desperate measures such as switching from disposable sensors to reusable sensors. In addition, our customers could also begin purchasing third party recycled sensors, rather than our new sensors, in an attempt to reduce their overall operating costs.

**\* Covidien may seek to avoid paying any royalties to us after March 15, 2014, which would significantly reduce our royalty revenue, total revenues and adversely affect our business, financial condition and results of operations.**

We are party to a settlement agreement with Covidien. Under the current settlement agreement, we earn royalties on Covidien's total U.S. based pulse oximetry sales. During the three months ended October 1, 2011, our royalties from the Covidien settlement agreement totaled \$6.4 million. Because these royalty payments do not carry any significant cost, they result in significant improvements to our reported gross profit, operating income levels and earnings per share. As a result, an elimination of royalties that we earn under the settlement agreement in the future will have a significant impact on our revenue, gross margins, operating income and earnings per share.

On January 28, 2011, we entered into a second amendment to this settlement agreement with Covidien. As part of this amendment, which became effective on March 15, 2011, Covidien has agreed to pay us a royalty at a rate of 7.75% of its United States pulse oximetry revenue, as that term is defined in the January 28, 2011 second amendment, from March 15, 2011 through at least March 15, 2014. In exchange for this royalty payment, we have provided Covidien with a covenant not to sue for its current pulse oximetry products, but not for any other technologies that Covidien may add, pursuant to the second amendment. After March 15, 2014, Covidien may stop paying us any royalties which would have a material adverse impact on our total revenue, gross margins, operating income and earnings per share.



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**Table of Contents**

**Risks Related to Our Intellectual Property**

**\* If the patents we own or license, or our other intellectual property rights, do not adequately protect our technologies, we may lose market share to our competitors and be unable to operate our business profitably.**

Our success depends significantly on our ability to protect our rights to the technologies used in our products, including Masimo SET and licensed rainbow<sup>®</sup> technology. We rely on patent protection, trade secrets, as well as a combination of copyright and trademark laws and nondisclosure, confidentiality and other contractual arrangements to protect our technology and rights. However, these legal means afford only limited protection and may not adequately protect our rights or permit us to gain or maintain any competitive advantage. In addition, we cannot be assured that any of our pending patent applications will result in the issuance of a patent to us. The U.S. Patent and Trademark Office, or PTO, may deny or require significant narrowing of claims in our pending patent applications, and patents issued as a result of the pending patent applications, if any, may not provide us with significant commercial protection or be issued in a form that is advantageous to us. We could also incur substantial costs in proceedings before the PTO. Our issued and licensed patents and those that may be issued or licensed in the future, may expire or may be challenged, invalidated or circumvented, which could limit our ability to stop competitors from marketing related technologies. Some of our patents related to our Masimo SET algorithm technology began to expire in March 2011. Additionally, upon expiration of other issued or licensed patents, we may lose some of our rights to exclude competitors from making, using, selling or importing products using the technology based on the expired patents. While we seek to offset potential losses relating to important expiring patents by securing additional patents on commercially desirable improvements, there can be no assurance that we will be successful in securing such additional patents, or that such additional patents will adequately offset the effect of expiring patents. We also must rely on contractual rights with the third parties that license technology to us to protect our rights in the technology licensed to us. There is no assurance that competitors will not be able to design around our patents. We also rely on unpatented proprietary technology. We cannot assure you that we can meaningfully protect all our rights in our unpatented proprietary technology or that others will not independently develop substantially equivalent proprietary products or processes or otherwise gain access to our unpatented proprietary technology.

We seek to protect our know-how and other unpatented proprietary technology with confidentiality agreements and intellectual property assignment agreements with our employees, our OEM partners, independent distributors and consultants. However, such agreements may not be enforceable or may not provide meaningful protection for our proprietary information in the event of unauthorized use or disclosure or other breaches of the agreements or in the event that our competitors discover or independently develop similar or identical designs or other proprietary information. In addition, we rely on the use of registered and common law trademarks with respect to the brand names of some of our products. Common law trademarks provide less protection than registered trademarks. Loss of rights in our trademarks could adversely affect our business, financial condition and results of operations.

Furthermore, the laws of foreign countries may not protect our intellectual property rights to the same extent as the laws of the U.S. If we fail to apply for intellectual property protection or if we cannot adequately protect our intellectual property rights in these foreign countries, our competitors may be able to compete more effectively against us, which could adversely affect our competitive position, as well as our business, financial condition and results of operations.

**If third parties claim that we infringe their intellectual property rights, we may incur liabilities and costs and may have to redesign or discontinue selling certain products.**

Companies in the medical device industry have used intellectual property litigation to gain a competitive advantage in the marketplace. We face the risk of claims that we have infringed on third parties' intellectual property rights. Searching for existing intellectual property rights may not reveal important intellectual property and our competitors may also have filed for patent protection, which is not publicly-available information, or claimed trademark rights that have not been revealed through our availability searches. In addition, many of our employees were previously employed at other medical device companies. We may be subject to claims that our employees have disclosed, or that we have used, trade secrets or other proprietary information of our employees' former employers. Our efforts to identify and avoid infringing on third parties' intellectual property rights may not always be successful. Any claims of patent or other intellectual property infringement against us, even those without merit, could:

increase the cost of our products;

be expensive and time consuming to defend;

result in us being required to pay significant damages to third parties;

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**Table of Contents**

force us to cease making or selling products that incorporate the challenged intellectual property;

require us to redesign, reengineer or rebrand our products, product candidates and technologies;

require us to enter into royalty or licensing agreements in order to obtain the right to use a third party's intellectual property on terms that may not be favorable or acceptable to us;

require us to indemnify third parties pursuant to contracts in which we have agreed to provide indemnification for intellectual property infringement claims;

divert the attention of our management and other key employees;

result in our customers or potential customers deferring or limiting their purchase or use of the affected products impacted by the claims until the claims are resolved; and

otherwise have a material adverse effect on our business, financial condition and results of operations.

In addition, new patents obtained by our competitors could threaten the continued commercialization of our products in the market even after they have already been introduced. In 2009, Philips Electronics North America Corporation filed antitrust and patent infringement counterclaims against us, as further explained in Part 1, Item 3 of our Annual Report on Form 10-K, filed with the SEC on February 16, 2011.

**We believe competitors may currently be violating and may in the future violate our intellectual property rights, and we may bring additional litigation to protect and enforce our intellectual property rights, which may result in substantial expense and may divert our attention from implementing our business strategy.**

We believe that the success of our business depends, in significant part, on obtaining patent protection for our products and technologies, defending our patents and preserving our trade secrets. We were previously involved in significant litigation to protect our patent position and may be required to engage in further litigation. In 2006, we settled a costly, six year lawsuit against Mallinckrodt, Inc., part of Tyco Healthcare (currently Covidien Ltd.), and one of its subsidiaries, Nellcor Puritan Bennett, Inc., in which we claimed that Covidien was infringing some of our pulse oximetry signal processing patents.

In February 2009, we filed a patent infringement suit against Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH related to Philips' FAST pulse oximetry technology and certain of Philips' patient monitors as described in Part 1, Item 3 of our Annual Report on Form 10-K, filed with the SEC on February 16, 2011, and Note 11 to the condensed consolidated financial statements. Both Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH are associated with Philips Medical Systems, an OEM partner of ours. There is no guarantee that we will prevail in this suit or receive any damages or other relief if we do prevail.

We believe that other competitors of ours, including GE Medical Systems and Mindray Medical International Ltd., may be infringing at least one of our patents. Our failure to pursue any potential claim could result in the loss of our proprietary rights and harm our position in the marketplace. Therefore, we may be forced to pursue litigation to enforce our rights. Our ongoing and future litigation could result in significant additional costs and further divert the attention of our management and key personnel from our business operations and the implementation of our business strategy and may not be adequate to protect our intellectual property rights.

**Risks Related to Our Regulatory Environment**

**\* Our failure to obtain and maintain FDA clearances or approvals on a timely basis, or at all, would prevent us from commercializing our current or upgraded products in the United States, which could severely harm our business.**



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Each medical device that we wish to market in the U.S. generally must first receive either 510(k) clearance from the FDA pursuant to the Federal Food, Drug, and Cosmetic Act by filing a 510(k) pre-market notification, or PMA, through submitting a PMA application. Even if regulatory clearance or approval of a product is granted, the clearance or approval may be subject to limitations on the indicated uses for which the product may be marketed. We cannot assure you that the FDA will grant 510(k) clearance on a timely basis, if at all, for new products or uses that we propose for Masimo SET or licensed rainbow<sup>®</sup> technology. The FDA's 510(k) clearance process of our products and uses has historically taken approximately four to six months. However, over the past year we have experienced a significantly longer 510(k) clearance review process. Our more recent experience in seeking FDA 510(k) clearance, along with information we have received from other medical device manufacturers, suggests that the FDA may have modified its 510(k) review protocol and process. Specifically, it appears that the FDA's medical device product reviews currently require applicants to provide much more information and data than in prior periods, the FDA is not consistently relying upon prior precedents thereby leading to more review cycles or, in some cases, to non-substantially equivalent decisions, and that the FDA has broadened the scope of its reviews. As a result, we have experienced lengthier FDA 510(k) review periods over the past 12 months, which has delayed the 510(k) clearance

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## **Table of Contents**

process for our products and uses over this period compared to prior periods. In addition, in September 2009, the FDA commissioned the Institute of Medicine to study the premarket notification program used to review and clear certain medical devices marketed in the U.S. It is believed that this study may result in formal changes to the FDA's 510(k) clearance review and approval processes which could potentially lengthen the review process of any future application of ours even further.

We have received FDA 510(k) clearance for the Pronto and Pronto-7 for noninvasive spot-checking of hemoglobin and other measurements in clinical and non-clinical settings, including blood donation facilities. Before commercializing either device in U.S. blood donation centers, we are also pursuing specific regulatory clearance from the FDA Center for Biologics Evaluation and Research, which regulates the collection of blood and blood components used for transfusion or for the manufacture of pharmaceuticals derived from blood and blood components.

To date, the FDA has regulated pulse oximeters incorporating Masimo SET and licensed rainbow® technology, and our sensors, cables and other products incorporating Masimo SET and licensed rainbow® technology for pulse oximetry under the 510(k) process. Although 510(k) clearances have been obtained for all of our current products, these clearances may be withdrawn by the FDA at any time if substantial safety or effectiveness problems develop with our devices. Furthermore, our new products or significantly modified marketed products could be denied 510(k) clearance and be required to undergo the more burdensome PMA process. The process of obtaining PMA is much more costly, lengthy and uncertain than the process for obtaining 510(k) clearance and generally takes one to three years, but may be longer.

**The failure of our OEM partners to obtain required FDA clearances or approvals for products that incorporate our technologies could have a negative impact on our revenue.**

Our OEM partners will be required to obtain their own FDA clearances for products incorporating Masimo SET and licensed rainbow® technology to market these products in the U.S. We cannot assure you that the FDA clearances we have obtained will make it easier for our OEM partners to obtain clearances of products incorporating these technologies, or that the FDA will ever grant clearances on a timely basis, if at all, for any future product incorporating Masimo SET and licensed rainbow® technology that our OEM partners propose to market.

**If we or our suppliers fail to comply with ongoing regulatory requirements, or if we experience unanticipated problems with our products, these products could be subject to restrictions or withdrawal from the market.**

Our products, along with the manufacturing processes and promotional activities for such products, are subject to continual review and periodic inspections by the FDA and other regulatory bodies. In particular, we and our suppliers are required to comply with FDA's Quality System Regulation, or QSR, which covers the methods and documentation of the design, testing, production, component suppliers control, quality assurance, labeling, packaging, storage and shipping of our products. The FDA enforces the QSR through announced and unannounced inspections. We are also subject to similar state requirements and licenses. Failure by us or one of our suppliers to comply with statutes and regulations administered by the FDA and other regulatory bodies, discovery of previously unknown problems with our products (including unanticipated adverse events or adverse events of unanticipated severity or frequency), manufacturing problems, or failure to comply with regulatory requirements, or failure to adequately respond to any FDA observations concerning these issues, could result in, among other things, any of the following actions:

warning letters or untitled letters issued by the FDA;

fines, civil penalties, injunctions and criminal prosecution;

unanticipated expenditures to address or defend such actions;

delays in clearing or approving, or refusal to clear or approve, our products;

withdrawal or suspension of clearance or approval of our products or those of our third-party suppliers by the FDA or other regulatory bodies;

product recall or seizure;

orders for physician notification or device repair, replacement or refund;

interruption of production; and

operating restrictions.

Furthermore, our key component suppliers may not currently be, or may not continue to be, in compliance with applicable regulatory requirements. If any of these actions were to occur, it would harm our reputation and adversely affect our business, financial condition and results of operations.

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## **Table of Contents**

### **Failure to obtain regulatory approval in foreign jurisdictions will prevent us from marketing our products abroad.**

We currently market and intend to continue to market our products internationally. Outside of the U.S., we can market a product only if we receive a marketing authorization and, in some cases, pricing approval, from the appropriate regulatory authorities. The regulatory registration/licensing process varies among international jurisdictions and may require additional testing. The time required for international registration of new products may differ from that required for obtaining FDA clearance. The foreign registration/licensing process may include all of the risks associated with obtaining FDA clearance in addition to other risks. We may not obtain foreign regulatory registration/licensing on a timely basis, if at all. FDA clearance does not ensure new product registration/licensing by foreign regulatory authorities. Approval by one foreign regulatory authority does not ensure approval by any other foreign regulatory authority or by the FDA. If we fail to receive necessary approvals to commercialize our products in foreign jurisdictions on a timely basis, or at all, our business, financial condition and results of operations could be adversely affected.

### **Modifications to our marketed devices may require new regulatory clearances or premarket approvals, or may require us to cease marketing or recall the modified devices until clearances or approvals are obtained.**

Any modifications to an FDA-cleared device that could significantly affect its safety or effectiveness or that would constitute a major change in its intended use would require a new 510(k) clearance or possibly a PMA approval. We may not be able to obtain such clearances or approvals in a timely fashion, or at all. Delays in obtaining future clearances would adversely affect our ability to introduce new or enhanced products in a timely manner, which in turn would have an adverse effect on our business, financial condition and results of operations. We have made modifications to our devices in the past and we may make additional modifications in the future. If the FDA disagrees with our conclusion and requires new clearances or approvals for the modifications, we may be required to recall and to stop marketing the modified devices, which could have an adverse effect on our business, financial conditions and results of operations. In particular, we are working to develop a replacement Pronto-7 rainbow<sup>®</sup> 4D sensor and it may require additional clearance or approvals.

### **Federal regulatory reforms may reduce the profit we are able to earn on the sale of our products.**

From time to time, legislation is drafted and introduced in Congress that could significantly change the statutory provisions governing the clearance or approval, manufacture and marketing of medical devices. In addition, FDA regulations and guidance are often revised or reinterpreted by the FDA in ways that may significantly affect our business and our products. It is impossible to predict whether legislative changes will be enacted or FDA regulations, guidance or interpretations changed, and what the impact of such changes, if any, may be. However, any changes could make it more difficult for us to maintain or attain approval to develop and commercialize our products and technologies.

### **If our products cause or contribute to a death or serious injury, we will be subject to medical device reporting regulations, which can result in voluntary corrective actions or agency enforcement actions, including recall of our products.**

Under the FDA medical device reporting regulations, we are required to report to the FDA any incident in which a product of ours may have caused or contributed to a death or serious injury or in which a product of ours malfunctioned and, if the malfunction were to recur, would likely cause or contribute to death or serious injury. In addition, all manufacturers placing medical devices in European Union markets are legally required to report to the relevant authority in whose jurisdiction any serious or potentially serious incidents occurred involving devices produced or sold by the manufacturer.

The FDA and similar foreign governmental authorities have the authority to require the recall of our commercialized products in the event of material deficiencies or defects, in for example, design, labeling or manufacture. In the case of the FDA, the authority to require a recall generally must be based on an FDA finding that there is a reasonable probability that the device would cause serious injury or death. Manufacturers may, under their own initiative, recall a product if any material deficiency in a device is found or we become aware of a safety issue involving a marketed product. A government-mandated or voluntary recall by us or by one of our distributors could occur as a result of component failures, manufacturing errors, design or labeling defects or other deficiencies and issues. We may initiate certain voluntary recalls involving our products in the future. Recalls of any of our products would divert managerial and financial resources and have an adverse effect on our financial condition and results of operations.

From our inception through October 1, 2011, we initiated five voluntary recalls of our products, none of which was material to our operating results. Each of these recalls was reported to the FDA within the appropriate regulatory timeframes. Because of our dependence upon patient and physician perceptions, any negative publicity associated with these or any future voluntary recalls could materially and adversely affect our business, financial condition, results of operations and growth prospects.



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**Table of Contents**

**Off-label promotion of our products or promotional claims deemed false or misleading could subject us to substantial penalties.**

Obtaining 510(k) clearance only permits us to promote our products for the uses specifically cleared by the FDA. Use of a device outside its cleared or approved indications is known as off-label use. Physicians may use our products off-label because the FDA does not restrict or regulate a physician's choice of treatment within the practice of medicine. Although we may request additional cleared indications for our current products, the FDA may deny those requests, require additional expensive clinical data to support any additional indications or impose limitations on the intended use of any cleared product as a condition of clearance. We must have adequate substantiation for our product performance claims. If the FDA determines that we or our OEM partners have promoted our products for off-label use or have made false or misleading or inadequately substantiated promotional claims, it could request that we or our OEM partners modify those promotional materials or take regulatory or enforcement actions, including the issuance of an untitled letter, a warning letter, injunction, seizure, civil fine and criminal penalties. It is also possible that other federal, state or foreign enforcement authorities might take action if they consider our promotional or training materials to constitute promotion of an uncleared or unapproved use, which could result in significant fines or penalties under other statutory authorities, such as laws prohibiting false claims for reimbursement. In that event, we would be subject to extensive fines and penalties and our reputation could be damaged and adoption of our products would be impaired. Although our policy is to refrain from statements that could be considered off-label promotion of our products, the FDA or another regulatory agency could conclude that we have engaged in off-label promotion. In addition, the off-label use of our products may increase the risk of injury to patients, and, in turn, the risk of product liability claims. Product liability claims are expensive to defend and could divert our management's attention and result in substantial damage awards against us.

**\* We may be subject to or otherwise affected by federal and state health care laws, including fraud and abuse and health information privacy and security laws, and could face substantial penalties if we are unable to fully comply with these laws.**

Although we do not provide health care services or receive payments directly from Medicare, Medicaid or other third-party payers for our products or the procedures in which our products are used, health care regulation by federal and state governments will impact our business. Health care fraud and abuse laws potentially applicable to our operations include, but are not limited to:

the Federal Health Care Programs Anti-Kickback Law, which prohibits, among other things, knowingly and willfully offering, paying, soliciting, or receiving any bribe, kickback or other remuneration intended to induce the purchase, order or recommendation of an item or service reimbursable under a federal health care program (such as the Medicare or Medicaid programs);

federal false claims laws which prohibit, among other things, knowingly and willfully presenting, or causing to be presented, claims for payment from Medicare, Medicaid, or other third-party payers that are false or fraudulent;

the federal provisions of the HIPAA established federal crimes for knowingly and willfully executing a scheme to defraud any health care benefit program or making false statements in connection with the delivery of or payment for health care benefits, items or services; and

state laws analogous to each of the above federal laws, such as state anti-kickback and false claims laws that may apply to items or services reimbursed by non-governmental third-party payers, including commercial insurers, and state laws governing the privacy of certain health information.

Federal and state false claims laws prohibit anyone from presenting, or causing to be presented, claims for payment to third-party payers that are false or fraudulent. For example, the federal Civil False Claims Act imposes liability on any person or entity who, among other things, knowingly and willfully presents, or causes to be presented, a false or fraudulent claim for payment by a federal health care program, including Medicaid and Medicare. Some suits filed under the Civil False Claims Act, known as qui tam actions, can be brought by a private individual, referred to as a whistleblower or relator, on behalf of the government and such individuals may share in any amounts paid by the entity to the government in fines or settlement. Such complaints are filed under seal and remain sealed until the applicable court orders otherwise. In recent years, the number of suits brought by private individuals has increased dramatically. Manufacturers, like us, can be held liable under false claims laws, even if they do not submit claims to the government, if they are found to have caused medical care providers to have submitted claims to the government for payment for a service or the use of a device that is not properly covered for government reimbursement. A number of states also have false claims laws, and some of these laws may apply to claims for items or services reimbursed under Medicaid and/or commercial insurance. Sanctions under these federal and state laws may include civil monetary penalties, exclusion of a manufacturer's products from

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reimbursement under government programs and imprisonment. In particular, when an entity is determined to have violated the federal Civil False Claims Act, it may be required to pay up to three times the actual damages sustained by the government, plus civil penalties of \$5,500 to

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**Table of Contents**

\$11,000 for each separate false claim. As previously disclosed, in November 2010 we voluntarily notified the FDA that we received allegations regarding the safety and efficacy of our Pronto and Pronto-7 products from certain former sales representatives of ours. In April 2011, we were informed by representatives of the U.S. Department of Justice that a qui tam complaint had been filed under seal against us by certain individuals. We are cooperating with the government's investigation. We continue to believe that our business practices comply in all material respects with applicable laws and regulations, but the investigation may involve some distraction to management and cause us to incur additional expenses.

We have certain arrangements with hospitals that may be affected by these laws. For instance, under our standard customer arrangements, we provide hospitals with free pulse oximetry monitoring devices in exchange for their agreement to purchase future pulse oximetry sensor requirements from us. In addition, we occasionally provide our customers with rebates in connection with their annual purchases. While we believe that these arrangements are structured such that we are currently in compliance with applicable federal and state health care laws, one or more of these arrangements may not meet the Federal Anti-Kickback Law's safe harbor requirements, which may result in increased scrutiny by government authorities that are responsible for enforcing these laws.

There can be no assurance that we will not be found to be in violation of any of such laws or other similar governmental regulations to which we are directly or indirectly subject, and as a result we may be subject to penalties, including civil and criminal penalties, damages, fines, exclusion of our products from reimbursement under Medicare, Medicaid and other federal health care programs, and the curtailment or restructuring of our operations. Any penalties could adversely affect our ability to operate our business and our financial results. Any action against us for violation of these laws, even if we successfully defend against them, could cause us to incur significant legal expenses and divert our management's attention from the operation of our business.

Further, we are required to comply with federal and state laws governing the transmission, security and privacy of individually identifiable health information that we may obtain or have access to in connection with manufacture and sale of our products. We may be required to make costly system modifications to comply with the HIPAA privacy and security requirements. Our failure to comply may result in criminal and civil liability because the potential for enforcement action against business associates is greater as a result of the Health Information Technology for Economic and Clinical Health Act.

Numerous other federal and state laws protect the confidentiality of patient information including state medical information privacy laws, state social security number protection laws and state and federal consumer protection laws. In some cases, more protective state privacy and security laws are not preempted by HIPAA and may be subject to interpretation by various governmental authorities and courts resulting in potentially complex compliance issues for us and our customers.

State and federal human subject protection laws apply to our receipt of individually identifiable health information in connection with clinical research. These laws could create liability for us if one of our research collaborators uses or discloses research subject information without authorization and in violation of applicable laws.

**Legislative and regulatory changes in the health care industry could have a negative impact on our financial performance. Furthermore, our business, financial condition, results of operations and cash flows could be significantly and adversely affected by recently enacted health care reform legislation in the U.S. or if reform programs are adopted in our key markets.**

Changes in the health care industry in the U.S. and elsewhere could adversely affect the demand for our products as well as the way in which we conduct our business. Significantly, President Obama signed health care reform legislation into law that will require most individuals to have health insurance, establish new regulations on health plans, and create insurance pooling mechanisms and other expanded public health care measures. This legislation also will reduce Medicare spending on services provided by hospitals and other providers and after December 31, 2012, impose a 2.3% tax on the sale of a taxable medical device by the manufacturer, producer or importer. Our operating expenses resulting from this excise tax and results of operations will be materially and adversely affected, if we are unable to pass the excise tax onto our customers.

Many details of the recently enacted health care reform legislation will be addressed in the implementing regulations. We cannot predict the effect any future legislation or regulation will have on us or what health care initiatives, if any, will be implemented at the state level. In general, an expansion in government's role in the U.S. health care industry may lower reimbursements for our products, reduce demand for innovative products, reduce medical procedure volumes and adversely affect our business and results of operations, possibly materially.

Furthermore, many private payers look to Medicare's coverage and reimbursement policies in setting their coverage policies and reimbursement amounts such that federal reforms could influence the private sector as well. Finally, many states also may attempt to reform their Medicaid programs such that either coverage for certain items or services may be narrowed or reimbursement for them could be reduced. These health



care reforms may adversely affect our business.

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## **Table of Contents**

Consistent with or in addition to Congressional or state reforms, the CMS, the federal agency that administers the Medicare and Medicaid programs could change its current policies that affect coverage and reimbursement for our products. CMS determined in 2007 that certain uses of pulse oximetry monitoring are eligible for separate Medicare payment in the hospital outpatient setting when no separately payable hospital outpatient services are reported on the same date of service. Each year, however, CMS re-examines the reimbursement rates for hospital inpatient and outpatient and physician office settings and could either increase or decrease the reimbursement rate for procedures utilizing our products. We are unable to predict when legislation or regulation that affects our business may be proposed or enacted in the future or what effect any such legislation or regulation would have on our business. Any such legislation, regulation or policies that affect the coverage and reimbursement of our current or future products, or the procedures utilizing our current or future products, could cause our sales to decrease and our revenue to decline.

In addition, the requirements or restrictions imposed on us or our products may change, either as a result of administratively adopted policies or regulations or as a result of the enactment of new laws. Such changes are particular possibilities in light of the 2008 elections in the U.S. There may be heightened scrutiny by federal and state regulators and legislators of the FDA's device approval process, the agency's efforts to assure the safety of marketed devices, and physician payments and promotional activities by manufacturers. Any new regulations or statutory provisions could result in delays or increased costs during the period of product development, clinical trials, and regulatory review and approval, as well as increased costs to assure compliance.

Further, our success in international markets also depends upon the eligibility of reimbursement for our products through government-sponsored health care payment systems and other third-party payers. Outside of the U.S., reimbursement systems vary by country. These systems are often subject to the same pressures to curb rising health care costs and control health care expenditures as those in the U.S. In addition, as economies of emerging markets develop, these countries may implement changes in their health care delivery and payment systems. If adequate levels of reimbursement from third-party payers outside of the U.S. are not obtained, sales of our products outside of the U.S. may be adversely affected.

### **Risks Related to Our Business and Operations**

**Cercacor has conducted most of the research and development of rainbow® technology and we are largely dependent upon Cercacor to develop improvements to certain rainbow® technologies.**

Cercacor has conducted the substantial majority of research and development of certain rainbow® technologies. Although we expect Cercacor to continue its research and development activities related to certain rainbow® technology and specific noninvasive monitoring measurements, including blood glucose and total hemoglobin, we have no assurance that it will do so. In the event Cercacor does not continue to develop and improve selected rainbow® technologies, our business, financial condition and results of operations could be adversely affected.

**We will experience conflicts of interest with Cercacor with respect to business opportunities and other matters.**

Prior to our initial public offering in August 2007, our stockholders owned 99% of the outstanding shares of capital stock of Cercacor and we believe that as of October 1, 2011, a number of stockholders of Cercacor continued to own shares of our stock. Joe Kiani, our Chairman and Chief Executive Officer, is also the Chairman and Chief Executive Officer of Cercacor.

Jack Lasersohn, another member of our board of directors, also serves on the board of directors of Cercacor. Due to the interrelated nature of Cercacor with us, conflicts of interest will arise with respect to transactions involving business dealings between us and Cercacor, potential acquisitions of businesses or products, development of products and technology, the sale of products, markets and other matters in which our best interests and the best interests of our stockholders may conflict with the best interests of the stockholders of Cercacor. We cannot assure you that any conflict of interest will be resolved in our favor, or that with respect to our transactions with Cercacor we will negotiate terms that are as favorable to us as if such transactions were with another third party.

**We will be required to pay Cercacor for the right to use certain improvements to Masimo SET that we develop.**

Under the Cross-Licensing Agreement, if we develop improvements to Masimo SET for the noninvasive monitoring of non-vital signs parameters, we would be required to assign these developments to Cercacor and then license the technology back from Cercacor in consideration for a license fee and royalty obligations to Cercacor. Therefore, any improvement to this technology would be treated as if it had been developed exclusively by Cercacor. In addition, we will not be reimbursed by Cercacor for our expenses relating to the development of any such technology. As a result of these terms, we may not generate any revenue from the further development of Masimo SET for the monitoring of non-vital signs parameters, which could adversely affect our business, financial condition and results of operations.



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**Table of Contents**

**We are required to pay royalties to Cercacor for all products sold that contain rainbow® technology, including certain annual minimum royalty payments, and this may impact our gross margins if we discontinue consolidating Cercacor within our financial statements.**

The Cross-Licensing Agreement requires us to pay Cercacor a royalty for all products that we sell which include their proprietary rainbow® technology. This includes handheld, table-top and multi-parameter products that incorporate licensed rainbow® technology. Beginning in 2009, for hospital contracts where we place equipment and enter into a sensor contract, we will pay a royalty to Cercacor on the total sensor contract revenue based on the ratio of rainbow® enabled devices to total devices. The agreement also requires that we make available to Cercacor, at its request, up to 10% of our annual board and sensor production volume at our total manufactured cost. In addition to these specific royalty and product obligations, our Cross-Licensing Agreement requires that we pay Cercacor specific annual minimum royalty payments.

Currently, we are required to consolidate Cercacor within our financial statements. Accordingly, the royalties that we owe to Cercacor are eliminated in our condensed consolidated financial statements presented within this Quarterly Report on Form 10-Q and our other periodic reports and the gross profit margins reported in our consolidated financial results do not include the royalty expense that we pay to Cercacor. We are also obligated to include, and have included, Cercacor's engineering and administrative expenses in our reported engineering and administrative expenses. If our financial statements were not consolidated with Cercacor, our reported cost of goods sold would increase and our reported engineering and administrative expenses would decrease. To date, the amount of royalty expense has approximated the amount of engineering and administrative expense. In the future, depending upon the success of rainbow® products and the royalties earned by Cercacor on those revenues, it is possible that the royalty expense will grow at a rate higher than the growth of engineering and administrative expenses. Should this occur, and if we were not required to consolidate Cercacor's financial results within our financial statements, then our unconsolidated cost of sales could grow at a faster rate than our unconsolidated engineering expenses.

Despite describing and reflecting this Cercacor consolidation requirement within our financial statements, failure to understand or appreciate the significance of our consolidation of Cercacor's financial statements may lead current and prospective investors to draw inaccurate perspectives and conclusions regarding our historical and future financial condition and results of operations.

**In the event that the Cross-Licensing Agreement is terminated for any reason, or Cercacor grants a license to rainbow® technology to a third party, our business would be materially and adversely affected.**

Cercacor owns all of the proprietary rights to rainbow® technology developed with our proprietary Masimo SET for products intended to be used in the Cercacor Market, and all rights for any non-vital signs measurement for which we do not exercise an option pursuant to the Cross-Licensing Agreement. In addition, Cercacor has the right to terminate the Cross-Licensing Agreement or grant licenses covering rainbow® technology to third parties if we breach certain terms of the agreement, including any failure to meet our minimum royalty payment obligations or failure to use commercially reasonable efforts to develop or market products incorporating licensed rainbow® technology. If we lose our exclusive license to rainbow® technology, we would lose the ability to prevent others from making, using, selling or importing products using rainbow® technology in our market. As a result, we would likely be subject to increased competition within our market, and Cercacor or competitors who obtain a license to rainbow® technology from Cercacor would be able to offer related products.

**We may not be able to commercialize our products incorporating licensed rainbow® technology cost-effectively or successfully.**

It is generally more expensive for us to make products that incorporate rainbow® technology that we license than products that do not include licensed rainbow® technology, due to increased production costs and the royalties that we must pay to Cercacor for the licenses. In order to successfully commercialize products incorporating licensed rainbow® technology, we must be able to pass these higher costs on to the market. We cannot assure you that we will be able to sell products incorporating licensed rainbow® technology at a price the market is willing to accept. If we cannot commercialize our products incorporating licensed rainbow® technology successfully, we may not be able to generate sufficient product revenue from these products to be profitable, which could adversely affect our business, financial condition and results of operations.

**Rights provided to Cercacor in the Cross-Licensing Agreement may impede a change in control of our company.**

In the event we undergo a change in control, we are required to immediately pay a \$2.5 million fee to exercise an option to license technology developed by Cercacor for use in blood glucose monitoring. Under the Cross-Licensing Agreement, a change in control includes, but is not limited to, the resignation or termination of Joe Kiani from his position of Chief Executive Officer of either Masimo or Cercacor. Additionally, our per product royalties payable to Cercacor will become subject to specified minimums, and the minimum aggregate annual royalties for all licensed rainbow® measurements payable to Cercacor is \$15.0 million for carbon monoxide, methemoglobin, fractional arterial oxygen saturation, total hemoglobin



## **Table of Contents**

and blood glucose, plus up to \$2.0 million per other rainbow® measurements. Also, if the surviving or acquiring entity ceases to use Masimo as a company name and trademark following a change in control, all rights to the Masimo trademark will automatically be assigned to Cercacor. This could delay or discourage transactions involving an actual or potential change in control of us, including transactions in which our stockholders might otherwise receive a premium for their shares over our then-current trading price. In addition, our requirement to assign all future improvements for non-vital signs to Cercacor could impede a change in control of our company.

### **We may experience significant fluctuations in our quarterly results in the future and we may not maintain our recent profitability and changes to existing accounting pronouncements or taxation rules may affect how we conduct our business and affect our reported results of operations.**

Our operating results have fluctuated in the past and are likely to fluctuate in the future. We may experience fluctuations in our quarterly results of operations as a result of:

delays or interruptions in manufacturing and shipping of our products;

varying demand for and market acceptance of our technologies and products;

the effect of competing technological and market developments resulting in lower selling prices or significant promotional costs;

changes in the timing of product orders and the volume of sales to our OEM partners;

actions taken by GPOs;

delays in hospital conversions to our products and declines in hospital patient census;

our legal expenses, particularly those related to litigation matters;

changes in our product or customer mix;

unanticipated delays or problems in the introduction of new products, including delays in obtaining clearance or approval from the FDA;

high levels of returns and repairs; and

change in reimbursement rates for SpHb, SpCO and SpMet parameters.

If our operating results fail to meet or exceed the expectations of securities analysts or investors, our stock price could drop suddenly and significantly. Our expense levels are based, in part, on our expectations regarding future revenue levels and are relatively fixed in the short term. As a result, if our revenue for a particular period was below our expectations, we would not be able to proportionately reduce our operating expenses for that period. Any revenue shortfall would have a disproportionately negative effect on our operating results for the period. Due to these and other factors, you should not rely on our results for any one quarter as an indication of our future performance.

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In addition, a change in accounting pronouncements or taxation rules or practices, or the interpretation of them by the SEC or other regulatory bodies, can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. New accounting pronouncements or taxation rules and varying interpretations of accounting pronouncements or taxation practice have occurred and may occur in the future. Changes to existing rules or the adoption of new rules may adversely affect our reported financial results or the way we conduct our business.

**If we lose the services of our key personnel, or if we are unable to attract and retain other key personnel, we may not be able to manage our operations or meet our growth objectives.**

We are highly dependent on our senior management, especially Joe Kiani, our Chief Executive Officer, and other key officers. We are also heavily dependent on our engineers and field sales team, including sales representatives and clinical specialists. Our success will depend on our ability to retain our current management, engineers and field sales team, and to attract and retain qualified personnel in the future, including scientists, clinicians, engineers and other highly skilled personnel. Competition for senior management, engineers and field sales personnel is intense and we may not be able to retain our personnel. In addition, some of our key personnel hold stock options with an exercise price that is greater than our recent closing prices, which may minimize the retention value of these options. The loss of the services of members of our key personnel could prevent the implementation and completion of our objectives, including the development and introduction of our products. In general, our officers may terminate their employment at any time without notice for any reason. We carry key person life insurance on only Mr. Kiani, who is also the Chief Executive Officer of Cercacor. Mr. Kiani devotes most of his time to us.

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**Table of Contents**

**Existing or future acquisitions of businesses could negatively affect our business, financial condition and results of operations if we fail to integrate the acquired businesses successfully into our existing operations or if we discover previously undisclosed liabilities.**

We have acquired four businesses since our inception and we may acquire additional businesses in the future. Successful acquisitions depend upon our ability to identify, negotiate, complete and integrate suitable acquisitions and to obtain any necessary financing. Even if we complete acquisitions, we may experience:

difficulties in integrating any acquired companies, personnel, products and other assets into our existing business;

delays in realizing the benefits of the acquired company, products or other assets;

diversion of our management's time and attention from other business concerns;

limited or no direct prior experience in new markets or countries we may enter;

higher costs of integration than we anticipated; and

difficulties in retaining key employees of the acquired business who are necessary to manage these acquisitions.

In addition, an acquisition could materially impair our operating results by causing us to incur debt or requiring us to amortize acquisition expenses and acquired assets. We may also discover deficiencies in internal controls, data adequacy and integrity, product quality, regulatory compliance and product liabilities that we did not uncover prior to our acquisition of such businesses, which could result in us becoming subject to penalties or other liabilities. Any difficulties in the integration of acquired businesses or unexpected penalties or liabilities in connection with such businesses could have a material adverse effect on our business, financial condition and results of operations.

**Our international business structure may not result in expected operational benefits.**

In 2008, we implemented a new international business structure designed to better serve and support our growing international business. By centralizing our international operations, including sales management, marketing, customer support, planning, logistics and administrative functions, we believe we will be able to develop a more efficient and scalable international organization capable of being even more responsive to the business needs of our international customers all under one centralized management structure. We commenced the implementation of an international business structure to align our operations with the business needs of our non-U.S. customers and we believe that we may, in the long run, also benefit from certain operational benefits and achieve a lower overall tax rate. However, there can be no assurance that our efforts will produce any anticipated operational benefits or provide an overall lower tax rate. Realization of the expected benefits will depend on a number of factors, including our future business results and profitability, the effectiveness and timing of our implementation of our international business structure, changes in U.S. or international tax law and the geographic composition of our pre-tax income. Legislative action may be taken by the U.S. Congress which, if ultimately enacted, could adversely affect our effective tax rate and/or require us to take further action, at potentially significant expense, to seek to preserve our effective tax rate. We cannot predict the outcome of any specific legislative proposals. However, if proposals were enacted that had a negative effect on our international business structure, we could be subjected to increased taxation and/or potentially significant expense.

**\* The risks inherent in operating internationally and the risks of selling and shipping our products and of purchasing our components and products internationally may adversely impact our business, financial condition and results of operations.**

We derive a portion of our net sales from international operations. During the three and nine months ended October 1, 2011, 28.0% and 29.0%, respectively, of our product revenue was derived from our international operations. In addition, we purchase a portion of our raw materials and components on the international market. The sale and shipping of our products across international borders, as well as the purchase of materials and components from international sources, subject us to extensive U.S. and foreign governmental trade regulations. Compliance with such



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regulations is costly and we would be exposed to potentially significant penalties for non-compliance. Any failure to comply with applicable legal and regulatory obligations could impact us in a variety of ways that include, but are not limited to, significant criminal, civil and administrative penalties, including imprisonment of individuals, fines and penalties, denial of export privileges, seizure of shipments, restrictions on certain business activities, and exclusion or debarment from government contracting. Also, the failure to comply with applicable legal and regulatory obligations could result in the disruption of our shipping, manufacturing and sales activities. Any material decrease in our international sales would adversely affect our business, financial condition and results of operations.

In addition, our international sales operations expose us and our representatives, agents and distributors to risks inherent in operating in foreign jurisdictions. These risks include, but are not limited to:

the imposition of additional U.S. and foreign governmental controls or regulations;

**Table of Contents**

the imposition of costly and lengthy new export licensing requirements;

a shortage of high-quality sales people and distributors;

loss of any key personnel that possess proprietary knowledge, or who are otherwise important to our success in certain international markets;

changes in duties and tariffs, license obligations and other non-tariff barriers to trade;

the imposition of new trade restrictions;

the imposition of restrictions on the activities of foreign agents, representatives and distributors;

scrutiny of foreign tax authorities which could result in significant fines, penalties and additional taxes being imposed on us;

pricing pressure that we may experience internationally;

laws and business practices favoring local companies;

political instability and actual or anticipated military or political conflicts;

longer payment cycles; and

difficulties in enforcing or defending intellectual property rights.

In addition, the U.S. Foreign Corrupt Practices Act and similar worldwide anti-bribery laws in non-U.S. jurisdictions generally prohibit companies and their intermediaries from making improper payments to non-U.S. officials for the purpose of obtaining or retaining business. Because of the predominance of government-sponsored health care systems around the world, many of our customer relationships outside of the U.S. are with governmental entities and are therefore subject to such anti-bribery laws. Our policies mandate compliance with these anti-bribery laws. Despite our training and compliance programs, our internal control policies and procedures may not always protect us from reckless or criminal acts committed by our employees or agents. Violations of these laws, or allegations of such violations, could subject us to cash and non-cash penalties, disrupt our operations, involve significant management distraction and result in a material adverse effect on our business, financial condition and results of operations.

**Our operations may be adversely impacted by our exposure to risks related to foreign currency exchange rates.**

We market our products in certain foreign markets through our subsidiaries and other international distributors. The related sales agreements may provide for payments in a foreign currency. A majority of our sales and expenditures are transacted in U.S. dollars. We transact with foreign customers in currencies other than the U.S. dollar. These foreign currency revenues, when converted into U.S. dollars, can vary depending on average exchange rates during a respective period. In addition, we are exposed to foreign currency gains or losses on outstanding foreign currency denominated receivables. When converted to U.S. dollars, these receivables can vary depending on the monthly exchange rates at the end of the period. Certain of our foreign sales support subsidiaries transact in their respective country's local currency, which is also their functional currency. As a result, expenses of these foreign subsidiaries when converted into U.S. dollars can vary depending on average monthly

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exchange rates during a respective period. Certain intercompany transactions may give rise to realized and unrealized foreign currency gains or losses. Accordingly, our operating results are subject to fluctuations in foreign currency exchange rates.

The balance sheets of our foreign subsidiaries whose functional currency is not the U.S. dollar are translated into U.S. dollars at the rate of exchange at the balance sheet date and the statements of income and cash flows are translated into U.S. dollars using the average monthly exchange rate during the period. Any foreign exchange gain or loss as a result of translating the balance sheets of our foreign subsidiaries whose functional currency is not the U.S. dollar is included in equity as a component of accumulated other comprehensive income.

We currently do not hedge against our foreign currency exchange rate risks and therefore believe our exposure to these risks may be higher than if we entered into hedging transactions, including forward exchange contracts or similar instruments. If we decide in the future to enter into forward foreign exchange contracts to attempt to reduce the risk related to foreign currency exchange rates, these contracts may not mitigate the potential adverse impact on our financial results due to the variability of timing and amount of payments under these contracts. In addition, these types of contracts may themselves cause financial harm to us and have inherent levels of counterparty risk over which we would have no control.

**We currently manufacture our products at two locations and any disruption in or expansion of our manufacturing operations could adversely affect our business, financial condition and results of operations.**

To date, we have relied on our manufacturing facilities in Irvine, California and Mexicali, Mexico. These facilities and the manufacturing equipment we use to produce our products would be difficult to replace and could require substantial time to

**Table of Contents**

repair. Our facilities may be affected by natural or man-made disasters. Earthquakes are of particular significance since both our Irvine, California and Mexicali, Mexico facilities are located in an earthquake-prone area. We are also vulnerable to damage from other types of disasters, including power loss, attacks from extremist organizations, fire, floods and similar events. In the event that one of our facilities was affected by a natural or man-made disaster, we would be forced to rely on third-party manufacturers if we could not shift production to our other manufacturing facility. Our insurance for damage to our property and the disruption of our business from casualties may not be sufficient to cover all of our potential losses and may not continue to be available to us on acceptable terms, or at all. If we are forced to seek alternative facilities, or if we voluntarily expand one or more of our manufacturing operations to new locations, we may incur additional transition costs and we may experience a disruption in the supply of our products until the new facilities are available and operating. We are also vulnerable to disruptions which may occur as a result of local, regional and worldwide health risks. Such disruptions may include the inability to manufacture and distribute our products due to the direct effects of illness on individuals or due to constraints on supply and distribution that may result from either voluntary or government imposed restrictions. Any disruption or delay at our manufacturing facilities and any expansion of our operations to additional locations could create operational hurdles and have an adverse impact on our ability to produce sufficient inventory of our products or may require us to incur additional expenses in order to produce sufficient inventory. In addition, any disruption, delay, transition or expansion of our manufacturing operations could impair our ability to meet the demand of our customers and our customers may cancel orders or purchase products from our competitors, which could adversely affect our business, financial condition and results of operations.

**Our suppliers may not supply us with a sufficient amount of materials and components or materials and components of adequate quality.**

We depend on sole or limited source suppliers for key materials and components of our noninvasive blood constituent patient monitoring solutions, and if we are unable to obtain these components on a timely basis, we will not be able to deliver our noninvasive blood constituent patient monitoring solutions to customers. Also, we cannot guarantee that any of the materials or components that we purchase, if available at all, will be of adequate quality. From time to time, there are industry-wide shortages of several electronic components that we use in our noninvasive blood constituent patient monitoring solutions. We may experience delays in production of our products if we fail to identify alternate vendors for materials and components, or any parts supply is interrupted or reduced or there is a significant increase in production costs, each of which could adversely affect our business, financial condition and results of operations.

**If we fail to comply with the reporting obligations of the Securities Exchange Act of 1934 and Section 404 of the Sarbanes-Oxley Act of 2002, or if we fail to maintain adequate internal control over financial reporting, our business, results of operations and financial condition and investors' confidence in us could be materially and adversely affected.**

As a public company, we are required to comply with the periodic reporting obligations of the Securities Exchange Act of 1934, as amended, or the Exchange Act, including preparing annual reports, quarterly reports and current reports. Our failure to prepare and disclose this information in a timely manner and meet our reporting obligations in their entirety could subject us to penalties under federal securities laws and regulations of The Nasdaq Stock Market LLC, expose us to lawsuits and restrict our ability to access financing on favorable terms, or at all.

In addition, pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, as amended, or the Sarbanes-Oxley Act, we are required to evaluate and provide a management report of our systems of internal control over financial reporting and our independent registered public accounting firm is required to attest to our internal control over financial reporting. During the course of the evaluation of our internal control over financial reporting, we may identify areas requiring improvement and may be required to design enhanced processes and controls to address issues identified through this review. This could result in significant delays and costs to us and require us to divert substantial resources, including management time from other activities. In addition, if we fail to maintain the adequacy of our internal controls over financial reporting, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal control over financial reporting in accordance with the Sarbanes-Oxley Act. Moreover, effective internal controls are necessary for us to produce reliable financial reports and are important to help prevent fraud. Any failure to maintain the requirements of Section 404 on a timely basis could result in the loss of investor confidence in the reliability of our financial statements, which in turn could harm our business, negatively impact the trading price of our stock, and adversely affect investors' confidence in our company and our ability to access capital markets for financing.

**If product liability claims are brought against us, we could face substantial liability and costs.**

The manufacture and sale of products using Masimo SET and licensed rainbow<sup>®</sup> technology expose us to product liability claims and product recalls, including, but not limited to, those that may arise from unauthorized off-label use, which is use of a device in a manner outside the measurement or measurements cleared by the FDA, or malfunction of, or design flaws or

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## **Table of Contents**

manufacturing defects in, our products or the use of our products with incompatible components or systems. Any losses that we may suffer from product liability claims, and the effect that any product liability litigation may have upon the reputation and marketability of our technology and products, together with the corresponding diversion of the attention of our key employees, may subject us to significant damages and could adversely affect our business, financial condition and results of operations. We cannot be certain that our product liability insurance will be sufficient to cover any or all damages or claims. Furthermore, we may not be able to obtain or maintain insurance in the future at satisfactory rates or in adequate amounts to protect us against any product liability claims.

### **We may incur environmental and personal injury liabilities related to certain hazardous materials used in our operations.**

Our manufacturing processes involve the use, generation and disposal of certain hazardous materials and wastes, including silicone adhesives, solder and solder paste, sealants, epoxies and various solvents such as methyl ethyl ketone, acetone and isopropyl alcohol. As a result, we are subject to stringent federal, state and local laws relating to the protection of the environment, including those governing the use, handling and disposal of hazardous materials and wastes. We may incur significant costs to comply with environmental regulations.

Future environmental laws may significantly affect our operations because, for instance, our manufacturing processes may be required to be altered, which may increase our manufacturing costs. In our research and manufacturing activities, we use, and our employees may be exposed to, materials that are hazardous to human health, safety or the environment. These materials and various wastes resulting from their use are stored at our facility pending ultimate use and disposal. The risk of accidental injury, including to our employees, or contamination from these materials cannot be eliminated. In the event of such an accident, we could be held liable for any resulting damages and any such liability could exceed our reserves. Although we maintain general liability insurance, we do not specifically insure against environmental liabilities. If an enforcement action were to occur, our reputation and our business and financial condition may be harmed, even if we were to prevail or settle the action on terms favorable to us.

### **Risks Related to Our Stock**

#### **\* Our stock price may be volatile, and your investment in our stock could suffer a decline in value.**

There has been significant volatility in the market price and trading volume of equity securities, which is often unrelated to the financial performance of the companies issuing the securities. These broad market fluctuations may negatively affect the market price of our stock. From July 3, 2011 to October 1, 2011, our closing stock price ranged from \$20.96 to \$30.91. You may not be able to resell your shares at or above the price you paid for them due to fluctuations in the market price of our stock caused by changes in our operating performance or prospects and other factors.

Some specific factors, in addition to the other risk factors identified above, may have a significant effect on our stock market price, many of which we cannot control. These include but are not limited to:

actual or anticipated fluctuations in our operating results or future prospects;

our announcements or our competitors' announcements of new products;

the public's reaction to our press releases, our other public announcements and our filings with the SEC;

strategic actions by us or our competitors, such as acquisitions or restructurings;

new laws or regulations or new interpretations of existing laws or regulations applicable to our business;

changes in accounting standards, policies, guidance, interpretations or principles;

changes in our growth rates or our competitors' growth rates;

developments regarding our patents or proprietary rights or those of our competitors;

ongoing legal proceedings;

our inability to raise additional capital as needed;

concerns or allegations as to the safety or efficacy of our products;

changes in financial markets or general economic conditions;

sales of stock by us or members of our management team, our board of directors or certain institutional stockholders; and

changes in stock market analyst recommendations or earnings estimates regarding our stock, other comparable companies or our industry generally.

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## **Table of Contents**

### **\* Concentration of ownership among our existing directors, executive officers and principal stockholders may prevent new investors from influencing significant corporate decisions.**

As of October 1, 2011, our current directors and executive officers and their affiliates, in the aggregate, beneficially owned 11.7% of our outstanding stock. Subject to any fiduciary duties owed to our other stockholders under Delaware law, the stockholders may be able to exercise a significant influence over matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, and will have some control over our management and policies. Some of these persons or entities may have interests that are different from yours. For example, these stockholders may support proposals and actions with which you may disagree or which are not in your best interests. The concentration of ownership could delay or prevent a change in control of us or otherwise discourage a potential acquirer from attempting to obtain control of us, which in turn could reduce the price of our stock. In addition, these stockholders could use their voting influence to maintain our existing management and directors in office, delay or prevent changes in control of us, or support or reject other management and board proposals that are subject to stockholder approval, such as amendments to our employee stock plans and approvals of significant financing transactions.

### **\* You could experience substantial dilution of your investment as a result of subsequent exercises of our outstanding options or the grant of future equity awards by us.**

As of October 1, 2011, an aggregate of 11,859,298 shares of our stock were reserved for future issuance under our three equity incentive plans, 7,026,015 of which were subject to options outstanding as of that date at a weighted average exercise price of \$23.02 per share. To the extent outstanding options are exercised, our existing stockholders may incur dilution. We rely heavily on equity awards to motivate current employees and to attract new employees. The grant of future equity awards by us to our employees and other service providers may further dilute our stockholders.

### **Future resales of our stock, including those by our insiders and a few investment funds, may cause our stock price to decline.**

A significant portion of our outstanding shares are held by directors, executive officers and a few investment funds. Resale by these stockholders of a substantial number of shares, announcements of the proposed resale of substantial amounts of our stock or the perception that substantial resales may be made, could significantly reduce the market price of our stock. Some of our directors and executive officers have entered into Rule 10b5-1 trading plans pursuant to which they have arranged to sell shares of our stock from time to time in the future. Generally, these sales require public filings. Actual or potential sales by these insiders, including those under a pre-arranged Rule 10b5-1 trading plan, could be interpreted by the market as an indication that the insider has lost confidence in our stock and reduce the market price of our stock.

We have registered and expect to continue to register shares reserved under our equity plans under a Registration Statement on Form S-8. All shares issued pursuant to a Registration Statement on Form S-8 can be freely sold in the public market upon issuance, subject to restrictions on our affiliates under Rule 144. If a large number of these shares are sold in the public market, the sales could reduce the trading price of our stock.

### **Our corporate documents and Delaware law contain provisions that could discourage, delay or prevent a change in control of our company, prevent attempts to replace or remove current management and reduce the market price of our stock.**

Provisions in our amended and restated certificate of incorporation and amended and restated bylaws may discourage, delay or prevent a merger or acquisition involving us that our stockholders may consider favorable. For example, our amended and restated certificate of incorporation authorizes our board of directors to issue up to five million shares of blank check preferred stock. As a result, without further stockholder approval, the board of directors has the authority to attach special rights, including voting and dividend rights, to this preferred stock. With these rights, preferred stockholders could make it more difficult for a third party to acquire us. In addition, our amended and restated certificate of incorporation provides for a staggered board of directors, whereby directors serve for three year terms, with one third of the directors coming up for reelection each year. A staggered board will make it more difficult for a third party to obtain control of our board of directors through a proxy contest, which may be a necessary step in an acquisition of us that is not favored by our board of directors.

We are also subject to the anti-takeover provisions of the Delaware General Corporation Law. Under these provisions, if anyone becomes an interested stockholder, we may not enter into a business combination with that person for three years without special approval, which could discourage a third party from making a takeover offer and could delay or prevent a change in control of us. An interested stockholder means, generally, someone owning 15% or more of our outstanding voting stock or an affiliate of ours that owned 15% or more of our outstanding voting stock during the past three years, subject to certain exceptions as described in the Delaware General Corporation Law.





## **Table of Contents**

In addition, we have adopted a stockholder rights plan. Under the stockholder rights plan if any person becomes the beneficial owner of 15% or more of the outstanding shares of stock, subject to a number of exceptions set forth in the plan, all of our stockholders other than the acquiring person will receive a right to purchase shares of our stock at a price of \$136.00 per share. Our stockholder rights plan could discourage a takeover attempt and make an unsolicited takeover of our company more difficult. As a result, without the approval of our board of directors, you may not have the opportunity to sell your shares to a potential acquirer of us at a premium over prevailing market prices. This could reduce the market price of our stock.

**\* We may elect to not declare cash dividends on our stock, may elect to only pay dividends on an infrequent or irregular basis, or we may elect to not make any stock repurchases, and any return on your investment may be limited to the value of our stock. However, the payment of any future dividends or the repurchase of our stock might limit our ability to pursue other growth opportunities.**

Our board of directors may from time to time declare, and we may pay, dividends on our outstanding shares in the manner and upon the terms and conditions provided by law. However, we may elect to retain all future earnings for the operation and expansion of our business, rather than paying cash dividends on our stock. Any payment of cash dividends on our stock will be at the discretion of our board of directors and will depend upon our results of operations, earnings, capital requirements, financial condition, business prospects, contractual restrictions and other factors deemed relevant by our board of directors. In the event our board of directors declares any dividends, there is no assurance with respect to the amount, timing or frequency of any such dividends.

In August 2011, our board of directors authorized a share repurchase program, whereby we may purchase up to 3 million shares of our common stock. Any repurchase of our common stock will be at the discretion of a committee comprised of our Chief Executive Officer and Chief Financial Officer, and will depend on several factors including, but not limited to, results of operations, capital requirements, financial conditions and the market price of our common stock. Therefore, there is no assurance with respect to the amount, price or timing of any such repurchases. We may elect to retain all future earnings for the operation and expansion of our business, rather than repurchasing any of our outstanding shares. In the event we pay dividends, or make any stock repurchases in the future, our ability to finance any material expansion of our business, including through acquisitions, investments or increased capital spending, or to fund our operations, may be limited. In addition, any repurchases we may make in the future may not prove to be at optimal prices.

### **Item 6. Exhibits**

The exhibits listed in the Exhibit Index immediately preceding the exhibits are filed as part of this Quarterly Report on Form 10-Q and such Exhibit Index is incorporated herein by reference.

**Table of Contents**

**SIGNATURES**

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.

**MASIMO CORPORATION**

Date: November 1, 2011

By: /s/ JOE KIANI  
Joe Kiani  
*Chief Executive Officer and Chairman*

Date: November 1, 2011

By: /s/ MARK P. DE RAAD  
Mark P. de Raad  
*Executive Vice President and Chief Financial Officer*

**Table of Contents****EXHIBIT INDEX**

<b>Exhibit</b>	<b>Number</b>	<b>Description of Document</b>
	2.1	(1) Asset Purchase Agreement, dated December 21, 2005, between the Company, Masimo Canada ULC and Andromed Inc. (Exhibit 2.1)
	2.1(a)	(1) List briefly identifying the contents of schedules omitted from Exhibit 2.1 (Exhibit 2.1(a))
	3.1	(1) Amended and Restated Certificate of Incorporation (Exhibit 3.2)
	3.2	(2) Certificate of Designation of Series A Junior Participating Preferred Stock (Exhibit 3.1)
	3.3	(3) Amended and Restated Bylaws adopted on October 20, 2011 (Exhibit 3.2)
	4.1	(1) Form of Common Stock Certificate (Exhibit 4.1)
	4.2	(2) Rights Agreement, dated November 9, 2007, between the Company and Computershare Trust Company, N.A., as Rights Agent (Exhibit 4.1)
	4.3	(4) Masimo Retirement Savings Plan. (Exhibit 4.7)
	12.1	Statement Regarding the Computation of Ratio of Earnings to Fixed Charges
	31.1	Certification of Joe Kiani, Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as amended
	31.2	Certification of Mark P. de Raad, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as amended
	32.1	Certification of Joe Kiani, Chief Executive Officer, and Mark P. de Raad, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as amended
101.INS		XBRL Instance Document
101.SCH		XBRL Taxonomy Extension Schema Document
101.CAL		XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF		XBRL Taxonomy Extension Definition Linkbase Document
101.LAB		XBRL Taxonomy Extension Label Linkbase Document
101.PRE		XBRL Taxonomy Extension Presentation Linkbase Document

Attached as Exhibit 101 to this report are documents formatted in XBRL (Extensible Business Reporting Language). Users of this data are advised that, pursuant to Rule 406T of Regulation S-T, the interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is otherwise not subject to liability under these sections.

- (1) Incorporated by reference to the exhibits to the Company's Registration Statement on Form S-1 (No. 333-142171) originally filed on April 17, 2007. The number given in parentheses indicates the corresponding exhibit number in such Form S-1, as amended.
- (2) Incorporated by reference to the exhibits to the Company's Current Report on Form 8-K filed on November 9, 2007. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.
- (3) Incorporated by reference to the exhibit to the Company's Current Report on Form 8-K filed on October 26, 2011. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.
- (4) Incorporated by reference to the exhibit to the Company's Registration Statement on Form S-8 filed on February 11, 2008. The number given in parentheses indicates the corresponding exhibit number in such Form S-8.  
Pursuant to Item 601(b)(2) of Regulation S-K, the schedules to this agreement have been omitted. A list identifying the contents of the omitted schedules is included as Exhibit 2.1(a). The Company agrees to furnish supplementally a copy of any omitted schedule to the

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Securities and Exchange Commission upon request.