

INTUITIVE SURGICAL INC
Form 10-Q
October 19, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

OR

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

For the transition period from _____ to _____

Commission file number 000-30713

Intuitive Surgical, Inc.

(Exact name of Registrant as specified in its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

950 Kifer Road

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

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Sunnyvale, California 94086

(Address of Principal Executive Offices including Zip Code)

(408) 523-2100

(Registrant's Telephone Number, Including Area Code)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The Registrant had 38,209,179 shares of Common Stock, \$0.001 par value per share, outstanding as of October 12, 2007.

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INTUITIVE SURGICAL, INC.

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Item 1. Financial Statements

INTUITIVE SURGICAL, INC.**CONDENSED CONSOLIDATED BALANCE SHEETS****(IN THOUSANDS)****(UNAUDITED)**

| | September 30, 2007 | December 31, 2006 |
|--|-------------------------------|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 86,393 | \$ 34,390 |
| Short-term investments | 282,565 | 205,353 |
| Accounts receivable, net | 120,456 | 94,680 |
| Inventory | 26,773 | 24,295 |
| Prepays | 13,918 | 6,328 |
| Deferred tax assets | 8,597 | 9,405 |
| Total current assets | 538,702 | 374,451 |
| Property, plant and equipment, net | 64,153 | 59,939 |
| Long-term investments | 164,531 | 90,553 |
| Long-term deferred tax assets | 27,614 | 22,272 |
| Intangible assets, net | 4,525 | 5,814 |
| Goodwill | 112,170 | 118,240 |
| Other assets | 552 | 521 |
| Total assets | \$ 912,247 | \$ 671,790 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 22,260 | \$ 11,092 |
| Accrued compensation and employee benefits | 22,728 | 21,091 |
| Deferred revenue | 47,624 | 36,559 |
| Other accrued liabilities | 11,052 | 11,925 |
| Total current liabilities | 103,664 | 80,667 |
| Long-term liabilities | 8,432 | 1,418 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock, 38,206 and 37,093 shares issued and outstanding as of September 30, 2007 and December 31, 2006 | 38 | 37 |
| Additional paid-in capital | 655,557 | 537,943 |
| Retained earnings | 144,356 | 51,020 |
| Accumulated other comprehensive income | 200 | 705 |
| Total stockholders' equity | 800,151 | 589,705 |

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| | | |
|--|------------|------------|
| Total liabilities and stockholders' equity | \$ 912,247 | \$ 671,790 |
|--|------------|------------|

See accompanying notes to condensed consolidated financial statements.

Table of Contents**INTUITIVE SURGICAL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)****(UNAUDITED)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenue: | | | | |
| Products | \$ 135,053 | \$ 81,433 | \$ 351,387 | \$ 221,312 |
| Services | 21,851 | 14,399 | 59,995 | 38,803 |
| Total revenue | 156,904 | 95,832 | 411,382 | 260,115 |
| Cost of revenue: | | | | |
| Products | 38,305 | 26,663 | 103,067 | 68,454 |
| Services | 10,129 | 6,936 | 29,229 | 18,770 |
| Total cost of revenue | 48,434 | 33,599 | 132,296 | 87,224 |
| Gross profit | 108,470 | 62,233 | 279,086 | 172,891 |
| Operating expenses: | | | | |
| Selling, general, and administrative | 40,163 | 28,578 | 112,989 | 79,652 |
| Research and development | 14,319 | 7,979 | 32,736 | 21,330 |
| Total operating expenses | 54,482 | 36,557 | 145,725 | 100,982 |
| Income from operations | 53,988 | 25,676 | 133,361 | 71,909 |
| Interest and other income, net | 12,220 | 3,146 | 22,060 | 8,602 |
| Income before taxes | 66,208 | 28,822 | 155,421 | 80,511 |
| Income tax expense | 25,289 | 11,559 | 60,037 | 32,108 |
| Net income | \$ 40,919 | \$ 17,263 | \$ 95,384 | \$ 48,403 |
| Earnings per share: | | | | |
| Basic | \$ 1.08 | \$ 0.47 | \$ 2.53 | \$ 1.32 |
| Diluted | \$ 1.04 | \$ 0.45 | \$ 2.46 | \$ 1.27 |
| Shares used in computing earnings per share: | | | | |
| Basic | 38,033 | 36,875 | 37,653 | 36,646 |
| Diluted | 39,271 | 38,184 | 38,776 | 38,044 |

See accompanying notes to condensed consolidated financial statements.

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

| | Nine Months Ended September 30, | |
|---|--|-----------------|
| | 2007 | 2006 |
| Operating Activities: | | |
| Net income | \$ 95,384 | \$ 48,403 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 8,016 | 5,656 |
| Amortization of intangible assets | 1,290 | 1,310 |
| Gain on sale of investments | (4,075) | |
| Deferred income taxes | (5,344) | 10,303 |
| Income tax benefits from employee stock option plans and acquisition | 56,770 | 19,511 |
| Excess tax benefit from stock-based compensation | (47,145) | (14,843) |
| Share-based compensation expense | 26,182 | 18,475 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (25,584) | (18,850) |
| Inventory | (2,444) | (7,055) |
| Prepays and other assets | (7,655) | (2,226) |
| Accounts payable | 11,128 | 2,217 |
| Deferred revenue | 11,184 | 8,605 |
| Accrued liabilities | 4,968 | 413 |
| Net cash provided by operating activities | 122,675 | 71,919 |
| Investing Activities: | | |
| Purchase of investments | (450,224) | (197,397) |
| Proceeds from sales and maturities of investments | 302,787 | 156,929 |
| Acquisition of property and equipment | (12,172) | (12,047) |
| Licensing of patents | | (2,200) |
| Net cash used in investing activities | (159,609) | (54,715) |
| Financing Activities: | | |
| Proceeds from issuance of common stock, net | 41,611 | 15,847 |
| Excess tax benefit from stock-based compensation | 47,145 | 14,843 |
| Net cash provided by financing activities | 88,756 | 30,690 |
| Effect of exchange rate changes on cash and cash equivalents | 181 | 43 |
| Net increase in cash and cash equivalents | 52,003 | 47,937 |
| Cash and cash equivalents, beginning of period | 34,390 | 5,508 |
| Cash and cash equivalents, end of period | \$ 86,393 | \$ 53,445 |

See accompanying notes to condensed consolidated financial statements.

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INTUITIVE SURGICAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

In this report, Intuitive Surgical, Intuitive, and the Company refer to Intuitive Surgical, Inc.

NOTE 1. DESCRIPTION OF BUSINESS

Intuitive Surgical, Inc. designs, manufactures, and markets the *da Vinci* Surgical System, which is an advanced surgical system that the Company believes represents a new generation of surgery. The *da Vinci* Surgical System consists of a surgeon's console, a patient-side cart, a high performance vision system and proprietary wristed instruments. The *da Vinci* Surgical System seamlessly translates the surgeon's natural hand movements on instrument controls at the console into corresponding micro-movements of instruments positioned inside the patient through small puncture incisions, or ports. The Company markets its products through sales representatives in the United States, and through a combination of sales representatives and distributors in its international markets.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

In the opinion of management, the accompanying Unaudited Condensed Consolidated Financial Statements (financial statements) of Intuitive Surgical, Inc., and its wholly-owned subsidiaries (collectively, the Company) have been prepared on a consistent basis with the December 31, 2006 audited consolidated financial statements and include all adjustments, consisting of only normal recurring adjustments, necessary to fairly state the information set forth herein. These financial statements have been prepared in accordance with the regulations of the Securities and Exchange Commission (SEC), and, therefore, omit certain information and footnote disclosures necessary to present the statements in accordance with accounting principles generally accepted in the United States of America. These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006, which was filed on February 15, 2007. The results of operations for the interim period ended September 30, 2007 are not indicative of the results to be expected for the entire fiscal year or any future periods.

Capitalized Software Costs for Internal Use

The Company capitalizes the costs of computer software developed or obtained for internal use in accordance with Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. Capitalized computer software costs consist of purchased software licenses and implementation and consulting costs for certain projects that qualify for capitalization. Costs related to preliminary project assessment, research and development, re-engineering, training and application management are all expensed as incurred. The Company capitalized costs for new enterprise software systems of \$6.5 million and \$3.8 million as of September 30, 2007 and December 31, 2006, respectively. Upon being placed in service, these costs are being depreciated over an estimated useful life of 5 years.

Segments

The Company operates in one segment. For the three and nine months ended September 30, 2007, 78% and 80%, respectively, and for the three and nine months ended September 30, 2006, 84% and 83%, respectively, of net revenue were generated in the United States.

Income Taxes

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (FAS 109). This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. The Company adopted FIN 48 effective January 1, 2007.

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As a result of the implementation of FIN 48, the Company recognized a \$2.0 million increase in liability for unrecognized tax benefits, which was accounted for as a reduction to the January 1, 2007 balance of retained earnings. In accordance with FIN 48, paragraph 19, the Company has decided to classify interest and penalties as a component of tax expense.

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As of September 30, 2007, the Company has total unrecognized tax benefits of approximately \$10.8 million compared with approximately \$5.7 million as of January 1, 2007, representing an increase of approximately \$5.1 million for the first nine months of fiscal 2007. Of the total unrecognized tax benefits, \$9.7 million, if recognized, would reduce our effective tax rate in the period of recognition. Interest and penalties are immaterial and are included in the unrecognized tax benefits.

The Company files federal, state and foreign income tax returns in many jurisdictions in the United States and abroad. For U.S. federal and California income tax purposes, the statute of limitation currently remains open for all years since inception due to utilization of net operating losses and research and development credits generated in prior years.

Recent Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 (SFAS No. 159). SFAS No. 159 expands the use of fair value accounting but does not affect existing standards which require assets or liabilities to be carried at fair value. The objective of SFAS No. 159 is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Under SFAS No. 159, a company may elect to use fair value to measure eligible items at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Eligible items include but are not limited to, accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and firm commitments. If elected, SFAS No. 159 is effective beginning January 1, 2008. We are currently assessing whether fair value accounting is appropriate for any of our eligible items and the impact, if any, it will have on our results of operations and financial position.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157) . SFAS No. 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning January 1, 2008. We are currently assessing the impact that SFAS No. 157 will have on our results of operations and financial position.

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|--|-------------------|------------------------------|-------------------------------|-------------------|
| September 30, 2007 | | | | |
| Short-term investments: | | | | |
| Commercial paper | \$ 25,505 | \$ 12 | \$ (4) | \$ 25,513 |
| Auction rate securities | 159,849 | 1 | | 159,850 |
| U.S. corporate debt | 77,810 | 19 | (99) | 77,730 |
| Government-sponsored enterprises | 19,488 | 3 | (19) | 19,472 |
| Total short-term investments | \$ 282,652 | \$ 35 | \$ (122) | \$ 282,565 |
| Long-term investments: | | | | |
| U.S. corporate debt | \$ 111,737 | \$ 277 | \$ (110) | \$ 111,904 |
| Government-sponsored enterprises | 52,518 | 109 | | 52,627 |
| Total long-term investments | \$ 164,255 | \$ 386 | \$ (110) | \$ 164,531 |
| Total short and long-term investments | \$ 446,907 | \$ 421 | \$ (232) | \$ 447,096 |
| December 31, 2006 | | | | |
| Short-term investments: | | | | |
| Commercial paper | \$ 60,395 | \$ | \$ (72) | \$ 60,323 |
| Auction rate securities | 82,250 | | | 82,250 |
| U.S. corporate debt | 39,076 | | (149) | 38,927 |
| U.S. government debt | 1,999 | | (4) | 1,995 |
| Government-sponsored enterprises | 21,985 | | (127) | 21,858 |
| Total short-term investments | \$ 205,705 | \$ | \$ (352) | \$ 205,353 |
| Long-term investments: | | | | |
| U.S. corporate debt | \$ 60,700 | \$ 56 | \$ (256) | \$ 60,500 |
| Government-sponsored enterprises | 27,998 | 9 | (93) | 27,914 |
| Publicly-traded equity securities | 896 | 1,243 | | 2,139 |
| Total long-term investments | \$ 89,594 | \$ 1,308 | \$ (349) | \$ 90,553 |
| Total short and long-term investments | \$ 295,299 | \$ 1,308 | \$ (701) | \$ 295,906 |

In the quarter ended September 30, 2007, the Company realized gains on the sale of publicly-traded equity securities of approximately \$4.1 million.

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The following is a summary of the amortized cost and estimated fair value of investments at September 30, 2007, by maturity date (in thousands):

| | Amortized Cost | Fair Value |
|------------------------------|-------------------|-------------------|
| Mature in less than one year | \$ 282,652 | \$ 282,565 |
| Mature in one to three years | 164,255 | 164,531 |
| Total | \$ 446,907 | \$ 447,096 |

NOTE 4. BALANCE SHEET DETAILS***Inventory***

The components of inventory are as follows (in thousands):

| | September 30, 2007 | December 31, 2006 |
|-----------------|-----------------------|----------------------|
| Raw materials | \$ 10,251 | \$ 9,389 |
| Work-in-process | 1,489 | 2,051 |
| Finished goods | 15,033 | 12,855 |
| Total | \$ 26,773 | \$ 24,295 |

Goodwill

The Company's goodwill amounts relate to the acquisition of Computer Motion, Inc. in June 2003. The changes in the carrying amount of goodwill for the nine months ended September 30, 2007 are due to the utilization of additional Computer Motion net operating loss carryforwards.

NOTE 5. STOCKHOLDERS' EQUITY***Comprehensive Income***

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

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| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------------|------------------------------------|------------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net income, as reported | \$ 40,919 | \$ 17,263 | \$ 95,384 | \$ 48,403 |
| Other comprehensive income: | | | | |
| Change in unrealized gain (loss) on available-for-sale securities, net of tax | (1,001) | 970 | (487) | 835 |
| Foreign currency translation adjustments | (21) | (2) | (18) | (49) |
| Comprehensive income | \$ 39,897 | \$ 18,231 | \$ 94,879 | \$ 49,189 |

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

| | September 30, 2007 | December, 31 2006 |
|--|-----------------------|----------------------|
| Accumulated net unrealized gain on available-for-sale securities, net of tax | \$ 112 | \$ 599 |
| Foreign currency translation adjustments | 88 | 106 |
| Total accumulated other comprehensive income | \$ 200 | \$ 705 |

Warrants

In conjunction with the Computer Motion acquisition in June 2003, the Company assumed warrants to purchase 724,729 shares of common stock at a weighted average exercise price of \$20.52 per share. The warrants were fully vested and immediately exercisable. Warrants for 79,306 shares of common stock were exercised at a weighted average price of \$12.84 and warrants for 7,843 shares of common stock expired during the first quarter of fiscal 2007. There are no remaining warrants outstanding.

Stock Option Plans

The Company has several stock-based compensation plans (the Plans) that are described in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006. The Company, under the various equity plans, grants stock options for shares of common stock to employees and directors. In accordance with the Plans, the stated exercise price for non-qualified stock options shall not be less than 85 percent of the estimated fair market value of common stock on the date of grant. Incentive stock options may not be granted at less than 100 percent of the estimated fair market value of the common stock. The Plans provide that the options shall be exercisable over a period not to exceed ten years. The majority of options granted under the Plans vest over a period of four years. Certain options granted under the Plans vest over shorter periods.

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A summary of stock option activity under the Plans for the nine months ended September 30, 2007 is presented as follows:

| | Number Outstanding | Stock Options Outstanding Weighted Average Exercise Price Per Share |
|--|-------------------------------|--|
| Balance at December 31, 2006 (with 1,729,923 options exercisable at a weighted-average exercise price of \$32.90 per share) | 3,420,587 | \$ 53.46 |
| Options granted | 1,006,707 | 121.48 |
| Options exercised | (929,653) | 36.99 |
| Options canceled/expired | (179,025) | 92.49 |
| Balance at September 30, 2007 (with 1,505,907 options exercisable at a weighted-average exercise price of \$49.07 per share) | 3,318,616 | \$ 76.61 |

Employee Stock Purchase Plan (ESPP)

Under the Employee Stock Purchase Plan, employees purchased approximately 36,000 shares for \$2.8 million and 104,000 shares for \$6.1 million during the three and nine months ended September 30, 2007.

Stock-based Compensation

The following table summarizes stock-based compensation charges:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Cost of sales - products | \$ 859 | \$ 667 | \$ 2,466 | \$ 1,788 |
| Cost of sales - services | 550 | 396 | 1,649 | 1,053 |
| Total cost of sales | 1,409 | 1,063 | 4,115 | 2,841 |
| Selling, general and administrative | 5,210 | 4,431 | 16,244 | 11,722 |
| Research and development | 2,107 | 1,456 | 5,823 | 3,913 |
| Stock-based compensation expense before income tax benefit | 8,726 | 6,950 | 26,182 | 18,476 |
| Income tax benefit | 3,070 | 2,526 | 9,196 | 6,617 |
| Stock-based compensation expense after income taxes | \$ 5,656 | \$ 4,424 | \$ 16,986 | \$ 11,859 |

The Black-Scholes option pricing model is used to estimate the fair value of stock options granted under the Company's stock-based compensation plans and rights to acquire stock granted under the Company's employee stock purchase plan. The weighted average estimated fair values of the stock options and rights to acquire stock granted under the Company's employee purchase plan as well as the weighted average assumptions used in calculating these values during the three and nine months ended September 30, 2007, were based on estimates at the date of grant as follows:

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| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|----------|
| | 2007 | 2006 | 2007 | 2006 |
| <u>Stock Options</u> | | | | |
| Average risk free interest rate | 4.68% | 4.93% | 4.68% | 4.84% |
| Average expected term (years) | 5.0 | 5.2 | 5.2 | 5.1 |
| Average expected volatility | 37% | 49% | 36% | 51% |
| Weighted average fair value at grant date | \$ 74.68 | \$ 53.36 | \$ 49.82 | \$ 56.15 |
| <u>ESPP</u> | | | | |
| Average risk free interest rate | 4.76% | 5.06% | 4.96% | 4.77% |
| Average expected term (years) | 1.3 | 1.3 | 1.3 | 1.3 |
| Average expected volatility | 37% | 50% | 39% | 51% |
| Weighted average fair value at grant date | \$ 69.46 | \$ 36.10 | \$ 51.40 | \$ 36.30 |

NOTE 6. RESTRUCTURING CHARGES

In January 2007, the Company announced that it is closing its operations in France and moving its international headquarters to Switzerland. The Company believes this restructuring will streamline its international operations and optimize its tax structure for the long term. The Company anticipates incurring restructuring costs of approximately \$820,000 through the end of 2009, primarily relating to employee severance arrangements, relocation costs and lease termination costs.

In accordance with SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, the Company recorded restructuring charges of approximately \$92,000 and \$747,000 during the three and nine months ended September 30, 2007, respectively, relating mainly to employee severance costs and lease termination costs. As of September 30, 2007, approximately \$234,000 remains to be paid and the Company expects to pay this by the end of fiscal 2009.

NOTE 7. INCOME TAXES

As part of the process of preparing the unaudited Condensed Consolidated Financial Statements, the Company is required to estimate its income taxes in each of the jurisdictions in which it operates. This process involves estimating the current tax liability under the most recent tax laws and assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in the unaudited Condensed Consolidated Balance Sheets.

Income tax expense for the three months ended September 30, 2007 was \$25.3 million, or 38.2% of pre-tax income, compared with \$11.6 million, or 40.1% of pre-tax income for the three months ended September 30, 2006. Income tax expense for the nine months ended September 30, 2007 was \$60.0 million, or 38.6% of pre-tax income, compared with \$32.1 million, or 39.9% of pre-tax income for the nine months ended September 30, 2006. The effective tax rate for the three and nine months ended September 30, 2007 differs from the U.S. federal statutory rate of 35% primarily due to state income taxes, partially offset by research and development credits generated in 2007 and domestic production deductions expected to be generated in 2007. The effective tax rate for the three and nine months ended September 30, 2006 differs from the federal statutory rate primarily due to state income taxes. The Company has net operating loss carryforwards and employee stock tax benefits that will be utilized in fiscal 2007. Approximately \$114 million of employee stock tax benefits have been generated in the nine months period ended September 30, 2007. As a result, the Company's cash outlay for taxes is expected to be between 5% and 10% of pretax income.

Table of Contents**NOTE 8. EARNINGS PER SHARE**

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net income | \$ 40,919 | \$ 17,263 | \$ 95,384 | \$ 48,403 |
| Weighted-average shares outstanding - Basic | 38,033 | 36,875 | 37,653 | 36,646 |
| Dilutive effect of employee stock option plans | 1,238 | 1,309 | 1,123 | 1,398 |
| Weighted-average shares outstanding - Diluted | 39,271 | 38,184 | 38,776 | 38,044 |
| Basic earnings per share | \$ 1.08 | \$ 0.47 | \$ 2.53 | \$ 1.32 |
| Diluted earnings per share | \$ 1.04 | \$ 0.45 | \$ 2.46 | \$ 1.27 |

Employee stock options to purchase approximately 64,000 and 1,002,400 shares for the three months ended September 30, 2007 and 2006, respectively, and 844,000 and 1,001,600 shares for the nine months ended September 30, 2007 and 2006, respectively, were outstanding, but were not included in the computation of diluted earnings per share because the effect would have been antidilutive.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

In this report, Intuitive Surgical, Intuitive, the Company, we, us, and our refer to Intuitive Surgical, Inc.

This management's discussion and analysis of financial condition as of September 30, 2007 and results of operations for the three and nine months ended September 30, 2007 and 2006 should be read in conjunction with management's discussion and analysis of financial condition and results of operations included in our Annual Report on Form 10-K for the year ended December 31, 2006.

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements relate to expectations concerning matters that are not historical facts. Words such as projects, believes, anticipates, plans, expects, intends and similar words and expressions are intended to identify forward-looking statements. These forward-looking statements include, but are not limited to, statements related to our expected business, new product introductions, results of operations, future financial position, our ability to increase our revenues, the mix of our revenues between product and service revenues, our financing plans and capital requirements, our costs of revenue, our expenses, our potential tax assets or liabilities, the effect of recent accounting pronouncements, our investments, cash flows and our ability to finance operations from cash flows and similar matters and include statements based on current expectations, estimates, forecasts and projections about the economies and markets in which we operate and our beliefs and assumptions regarding these economies and markets. Readers are cautioned that these forward-looking statements are based on current expectation and are subject to risks, uncertainties, and assumptions that are difficult to predict, including those risk factors described throughout this filing and detailed in the Annual Report on Form 10-K for the fiscal year ended December 31, 2006 and other periodic filings with the Securities and Exchange Commission, particularly in Part I, Item 1A: Risk Factors. Our actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

Intuitive®, *da Vinci*®, *da Vinci*®S, *TilePro*, *Solo Surgery*, *EndoWristSite*®, AESOP®, HERMES®, ZEUS®, SOCRATES and *Navigator* are trademarks of Intuitive Surgical, Inc.

Overview

Products. We design, manufacture and market *da Vinci* Surgical Systems, which are advanced surgical systems that we believe represent a new generation of surgery. The *da Vinci* Surgical System consists of a surgeon's console, a patient-side cart and a high performance vision system. The product line also includes proprietary wristed instruments and surgical accessories. The *da Vinci* Surgical System seamlessly translates the surgeon's natural hand movements on instrument controls at a console into corresponding micro-movements of instruments positioned inside the patient through small puncture incisions, or ports. We believe that the *da Vinci* Surgical System is the only commercially available technology that can provide the surgeon with intuitive control, range of motion, fine tissue manipulation capability and 3-D HD visualization, while simultaneously allowing the surgeons to work through the small ports of minimally invasive surgery, or MIS. By placing computer-enhanced technology between the surgeon and the patient, we believe that the *da Vinci* Surgical System enables surgeons to improve clinical outcomes while reducing the invasiveness of complex surgical procedures. The *da Vinci* Surgical System is sold into multiple surgical specialties, principally urology, gynecology, cardiothoracic, and general surgery.

Business Model. In our business model, we generate revenue from both the initial capital sales of *da Vinci* Surgical Systems as well as recurring revenue, comprised of instrument, accessory, service, and training revenue. The *da Vinci* Surgical System generally sells for approximately \$1.0 million to \$1.7 million, depending on configuration, and represents a significant capital equipment investment for our customers. We then generate recurring revenue as our customers purchase our *EndoWrist* instruments and accessory products for use in performing procedures with the *da Vinci* Surgical System. *EndoWrist* instruments and accessories will either expire or wear out as they are used in surgery and will need to be replaced as they are consumed. We generate additional recurring revenue from ongoing system service and customer training. We typically enter into service contracts at the time the system is sold. These service contracts have been generally renewable at the end of the service period, typically at an annual rate of approximately \$100,000 to \$150,000 per year, depending on configuration of the underlying system.

Since the introduction of the *da Vinci* Surgical System in 1999, our established base of *da Vinci* Surgical Systems has grown and robotic surgery volume has increased. Recurring revenue has grown at an equal or faster rate than system revenue. Over the past five years, revenue generated from the sale of instruments and accessories, service and training increased from 22% of revenue in 2002 to 45% of revenue in 2006. Recurring revenue for the three months ended September 30, 2007 was \$71.4 million, or 45% of total revenue, and for the nine months ended September 30, 2007 was \$195.6 million, or 48% of total revenue. We expect recurring revenue to become a larger percentage of total revenue in the future.

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Regulatory Activities

We believe that we have obtained clearances required to market our products to our targeted surgical specialties within the United States. As we make additions to target procedures, we will continue to obtain the necessary clearances. The following table lists chronologically our FDA clearances to date:

July 2000 General laparoscopic procedures

March 2001 Non-cardiac thoracoscopic procedures

May 2001 Prostatectomy procedures

November 2002 Cardiomy procedures

July 2004 Cardiac revascularization procedures

March 2005 Urologic surgical procedures

April 2005 Gynecologic surgical procedures

June 2005 Pediatric surgical procedures

In an October of 2007 Enforcement report from FDA, the FDA reported on two corrections and removals conducted by Intuitive for our systems. Intuitive has addressed these issues through field inspections and corrections using our field service organization. As part of our quality system, we take a pro-active approach in upgrading software in our field systems routinely and in monitoring system performance. These actions are reviewed by FDA and are periodically reported if they meet certain criteria for public reporting. We believe our quality systems are functioning properly and we continue to work with FDA and agencies worldwide to satisfy their reporting requirements.

2007 Business Events and Trends

Introduction. We experienced rapid growth during 2006 and through the third quarter of 2007, which was driven by the continued adoption of the *da Vinci* Surgical System for use in urologic, gynecologic, cardiothoracic, and general surgeries.

Third Quarter 2007 Financial Highlights

Total revenue grew 64% to \$156.9 million from \$95.8 million during the third quarter of 2006.

Recurring revenue grew 64% to \$71.4 million from \$43.4 million during the third quarter of 2006.

Instruments and accessories revenue grew 70% to \$49.5 million from \$29.0 million during the third quarter of 2006.

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We sold 63 *da Vinci* Surgical Systems during the third quarter of 2007, an increase of 37% compared with 46 in the third quarter of 2006.

As of September 30, 2007, we had a *da Vinci* Surgical System installed base of 719 systems 545 in the United States, 119 in Europe, and 55 in the rest of the world.

Operating income increased by 110% to \$54.0 million, or 34% of revenue, from \$25.7 million, or 27% of revenue, during the third quarter of 2006. Operating income included \$8.7 million and \$7.0 million during the third quarter of 2007 and 2006, respectively, of stock-based compensation expense for the estimated fair value of employee stock options and stock purchases.

Our business continues to demonstrate the ability to generate positive cash flow while supporting our business growth. Cash, cash equivalents, and investments increased by \$86.0 million, including \$21.4 million of proceeds from employee stock programs, from the second quarter of 2007, as we ended the third quarter of 2007 with \$533.5 million in cash, cash equivalents, and investments.

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Procedure adoption

We believe the adoption of *da Vinci* surgery occurs surgical procedure by surgical procedure, and it is being adopted for those procedures which offer significant patient value. The value of a surgical procedure to a patient is higher if it offers superior clinical outcomes, less surgical trauma, or both.

The procedures that have driven the most growth in our business recently are the *da Vinci* Prostatectomy (dVP) and the *da Vinci* Hysterectomy (dVH). During 2006 and the first nine months of 2007, dVP procedures represented more than half of all the *da Vinci* surgical procedures. We expect dVP procedures to grow more than 65% from 2006 to 2007. The dVH procedure was our fastest growing procedure from a percentage growth standpoint in 2006 and the first nine months of 2007, and it is expected to grow more than 175% from 2006 to 2007.

New Products

In January 2007, we launched the high definition (HD) vision system in the United States. The HD vision system provides 20% more viewing area and enhances visualization of tissue planes and critical anatomy compared with our standard vision system. The digital zoom feature in the 3-D HD vision system allows surgeons to magnify the surgical field of view without adjusting endoscope position and reduces interference between the endoscope and instruments. We believe the new 3-D HD vision system enables improved surgical outcomes. The 3-D HD vision is available as an option on new *da Vinci* S Surgical Systems and as an upgrade option to our existing customers who own a *da Vinci* S Surgical System. During the third quarter of 2007, 35 of the 46 *da Vinci* S systems sold in the United States were 3-D HD systems. We launched the 3-D HD vision system for our international customers in May 2007 and 8 of the 14 *da Vinci* S systems sold outside the United States during the third quarter of 2007 were 3-D HD systems. We expect a majority of the systems sold in the future to be *da Vinci* S Systems with HD vision system, but we do not expect 3-D HD upgrades to comprise a significant portion of revenue in the future.

During the second quarter of 2007, we launched the 3-arm *da Vinci* S Surgical System. The 3-arm *da Vinci* S Surgical System shares the same core functionality of the *da Vinci* S Surgical System including a streamlined interface, a motorized patient cart, quick-click cannula mounts and single-use sterile adapters for rapid instrument exchange. The 3-arm *da Vinci* S Surgical System includes a standard definition 3D vision system and a patient-side cart with two instrument arms. The 3-arm *da Vinci* S Surgical System is an addition to the *da Vinci* S product line and can be upgraded in the future to the full capability of a 4-arm *da Vinci* S system with HD vision. We sold four 3-arm *da Vinci* S during the three months ended September 30, 2007.

During the third quarter of 2007, we introduced the EndoWrist Large Hem-o-lok[®] Clip Applier, a new 8mm EndoWrist Clip Applier, that provides the surgeon direct control in placing large Hem-o-lok[®] polymer clips. The EndoWrist Large Hem-o-lok[®] Clip Applier was developed in collaboration with Teleflex Medical, a division of Teleflex Corporation.

Table of Contents**RESULTS OF OPERATIONS**

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

| | Three months Ended | | | | Nine months Ended | | | |
|--------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2007 | % of total revenue | September 30, 2006 | % of total revenue | September 30, 2007 | % of total revenue | September 30, 2006 | % of total revenue |
| Revenue: | | | | | | | | |
| Products | \$ 135,053 | 86% | \$ 81,433 | 85% | \$ 351,387 | 85% | \$ 221,312 | 85% |
| Services | 21,851 | 14% | 14,399 | 15% | 59,995 | 15% | 38,803 | 15% |
| Total revenue | 156,904 | 100% | 95,832 | 100% | 411,382 | 100% | 260,115 | 100% |
| Cost of revenue: | | | | | | | | |
| Products | 38,305 | 24% | 26,663 | 28% | 103,067 | 25% | 68,454 | 27% |
| Services | 10,129 | 7% | 6,936 | 7% | 29,229 | 7% | 18,770 | 7% |
| Total cost of revenue | 48,434 | 31% | 33,599 | 35% | 132,296 | 32% | 87,224 | 34% |
| Products gross profit | 96,748 | 62% | 54,770 | 57% | 248,320 | 60% | 152,858 | 58% |
| Services gross profit | 11,722 | 7% | 7,463 | 8% | 30,766 | 8% | 20,033 | 8% |
| Gross profit | 108,470 | 69% | 62,233 | 65% | 279,086 | 68% | 172,891 | 66% |
| Operating expenses: | | | | | | | | |
| Selling, general, and administrative | 40,163 | 26% | 28,578 | 30% | 112,989 | 27% | 79,652 | 30% |
| Research and development | 14,319 | 9% | 7,979 | 8% | 32,736 | 8% | 21,330 | 8% |
| Total operating expenses | 54,482 | 35% | 36,557 | 38% | 145,725 | 35% | 100,982 | 38% |
| Income from operations | 53,988 | 34% | 25,676 | 27% | 133,361 | 33% | 71,909 | 28% |
| Interest and other income, net | 12,220 | 8% | 3,146 | 3% | 22,060 | 5% | 8,602 | 3% |
| Income before taxes | 66,208 | 42% | 28,822 | 30% | 155,421 | 38% | 80,511 | 31% |
| Income tax expense | 25,289 | 16% | 11,559 | 12% | 60,037 | 15% | 32,108 | 12% |
| Net income | \$ 40,919 | 26% | \$ 17,263 | 18% | \$ 95,384 | 23% | \$ 48,403 | 19% |

Total Revenue

Total revenue increased to \$156.9 million for the three months ended September 30, 2007 from \$95.8 million for the three months ended September 30, 2006. For the nine months ended September 30, 2007, revenue increased to \$411.4 million from \$260.1 million for the nine months ended September 30, 2006. First nine months of 2007 revenue growth was driven by the continued adoption of *da Vinci* surgery. We believe that robotic surgery will be adopted surgical procedure by surgical procedure. Our revenue growth during the periods presented reflects adoption progress made in our target procedures. dVP has been our most successful procedure to date and has been a significant sales catalyst. An increasing body of clinical evidence has indicated that dVP offers superior surgical outcomes compared to traditional open prostatectomy in the critical categories of cancer removal, continence, and sexual potency. In 2006, dVH emerged as our fastest growing procedure on a percentage of growth basis. Favorable clinical results have been reported in hysterectomies for cancerous pathology, which include increased lymph node retrieval counts and significant reduction in blood transfusion. For most patients, a minimally invasive approach using the *da Vinci* Surgical System offers reduced pain, less blood loss, shorter hospital stays and a quicker return to normal daily activities.

Revenue within the United States accounted for 78% and 80% of total revenue for the three months and nine months ended September 30, 2007, respectively, and 84% and 83% of total revenue for the three months and nine months ended September 30, 2006, respectively. We believe

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domestic revenue accounts for the large majority of total revenue due primarily to the competitive nature of the domestic healthcare market. We also believe that at this stage, as we penetrate the early adopters of robotic surgery, revenue will continue to be concentrated in the U.S. market, as U.S. hospitals are generally more willing to invest in technology that will drive incremental patients into their healthcare systems. We expect that as adoption progresses and as we reach standard of care for target procedures, international revenue will increase as a percentage of overall revenue.

The following table summarizes our revenue and *da Vinci* Surgical System unit sales for the three and nine months ended September 30, 2007 and 2006 (in millions, except unit sales):

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| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|---------|------------------------------------|----------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenue | | | | |
| Instruments and accessories | \$ 49.5 | \$ 29.0 | \$ 135.6 | \$ 78.4 |
| Systems | 85.5 | 52.4 | 215.8 | 142.9 |
| Total product revenue | 135.0 | 81.4 | 351.4 | 221.3 |
| Services and training | 21.9 | 14.4 | 60.0 | 38.8 |
| Total revenue | \$ 156.9 | \$ 95.8 | \$ 411.4 | \$ 260.1 |
| Recurring revenue | \$ 71.4 | \$ 43.4 | \$ 195.6 | \$ 117.2 |
| % of total revenue | 45% | 45% | 48% | 45% |
| Domestic | \$ 123.1 | \$ 80.9 | \$ 329.7 | \$ 216.9 |
| International | 33.8 | 14.9 | 81.7 | 43.2 |
| Total revenue | \$ 156.9 | \$ 95.8 | \$ 411.4 | \$ 260.1 |
| <i>da Vinci</i> Surgical System unit sales | 63 | 46 | 163 | 120 |

Product Revenue

Product revenue increased to \$135.0 million for the three months ended September 30, 2007 from \$81.4 million for the three months ended September 30, 2006. The \$53.6 million (66%) increase was due to higher volume of instruments and accessories, and systems sales.

Instruments and accessories revenue increased to \$49.5 million for the three months ended September 30, 2007, up 70% compared with \$29.0 million for the three months ended September 30, 2006. The increase is driven by a similar increase in procedures. The hysterectomy procedure was the fastest growing procedure on a percentage basis and prostatectomy was the largest volume procedure.

Systems revenue increased to \$85.5 million during the three months ended September 30, 2007 from \$52.4 million during the three months ended September 30, 2006, primarily due to the growth in the number of systems reflecting adoption of robotic surgery and increased average selling price (ASPs) resulting from the higher priced *da Vinci* S and *da Vinci* S HD Surgical Systems and the favorable foreign exchange impact of Euro-denominated sales. We sold 63 *da Vinci* Surgical Systems during the three months ended September 30, 2007 compared with 46 systems sold during the three months ended September 30, 2006. Of the 63 systems sold during the three months ended September 30, 2007, 43 were 3-D HD systems. In addition, we recognized revenue from HD and fourth arm upgrades of \$1.6 million during the three months ended September 30, 2007 compared with \$0.5 million of fourth arm upgrades during the three months ended September 30, 2006. The average revenue recognized per *da Vinci* system was \$1.3 million during the three months ended September 30, 2007, compared with \$1.1 million during the three months ended September 30, 2006.

Product revenue increased to \$351.4 million for the nine months ended September 30, 2007 from \$221.3 million for the nine months ended September 30, 2006. The \$130.1 million (59%) increase was due to higher instruments and accessories, and systems revenue.

Instruments and accessories revenue increased to \$135.6 million for the nine months ended September 30, 2007, up 73% compared with \$78.4 million for the nine months ended September 30, 2006. The increase for the nine months ended September 30, 2007 is the result of the same factors as the three months ended September 30, 2007.

Systems revenue increased to \$215.8 million during the nine months ended September 30, 2007 from \$142.9 million during the nine months ended September 30, 2006, primarily due to the growth in the number of systems reflecting adoption of robotic surgery and increased ASPs resulting from the higher priced *da Vinci* S and *da Vinci* S HD Surgical Systems. We sold 163 *da Vinci* Surgical Systems during the nine months ended September 30, 2007, compared with 120 systems sold during the nine months ended September 30, 2006. Of the 163 systems sold during the nine months ended September 30, 2007, 102 were 3-D HD systems. In addition, we

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recognized revenue from HD and fourth arm upgrades of \$3.8 million during the nine months ended September 30, 2007 compared with \$1.9 million of fourth arm upgrades during the nine months ended September 30, 2006. The average revenue recognized per *da Vinci* system was \$1.3 million during the nine months ended September 30, 2007, compared with \$1.2 million during the nine months ended September 30, 2006.

Service and Training Revenue

Service and training revenue increased to \$21.9 million for the three months ended September 30, 2007 from \$14.4 million for the three months ended September 30, 2006. We typically enter into service contracts at the time systems are sold. These service contracts have been generally renewed at the end of the service period. Higher service revenue for third quarter of 2007 was driven by a larger base of *da Vinci* Surgical Systems producing contract service revenue and higher revenue earned per system under service contract. There were approximately 656 systems under service contract entering the third quarter of 2007 generating approximately \$33,000 per system for the quarter, compared to approximately 467 systems entering the third quarter of 2006 generating approximately \$31,000 per system for the quarter. The increase in service revenue per system was driven by a higher percentage of four-arm *da Vinci* Systems and *da Vinci S* Surgical Systems in the third quarter of 2007 installed base. *da Vinci S* Surgical Systems carry a higher contractual service rate than four-arm *da Vinci* Systems which in turn have higher contractual service rates than three-arm systems.

Service and training revenue increased to \$60.0 million for the nine months ended September 30, 2007 from \$38.8 million for the nine months ended September 30, 2006. Higher service revenue for the first nine months of 2007 was driven by a larger base of *da Vinci* Surgical Systems producing contract service revenue and higher revenue earned per system under service contract. The increase in service revenue per system was driven by a higher percentage of *da Vinci S* and *da Vinci S HD* Surgical Systems in the installed base during the nine months ended September 30, 2007.

Gross Profit

Product gross profit during the three and nine months ended September 30, 2007 was \$96.7 million, or 72% of product revenue, and \$248.3 million, or 71% of product revenue, respectively, compared with \$54.8 million, or 67% of product revenue, and \$152.9 million, or 69% of product revenue, during the three and nine months ended September 30, 2006, respectively. The higher product gross profit was driven by higher 2007 product revenue, as described above. The higher 2007 product gross profit percentage was driven by the higher 2007 *da Vinci* Surgical Systems ASPs, instrument material cost reductions and favorable manufacturing absorption. Product gross profit for the three and nine months ended September 30, 2007 and 2006 included stock-based compensation expense of \$0.9 million and \$2.5 million, and \$0.7 million and \$1.8 million, respectively.

Service gross profit during the three and nine months ended September 30, 2007 was \$11.7 million, or 54% of service revenue, and \$30.8 million, or 51% of service revenue, respectively, compared with \$7.5 million, or 52% of service revenue, and \$20.0 million, or 52% of service revenue, during the three and nine months ended September 30, 2006, respectively. The higher 2007 service gross profit was driven by higher service revenue, as described above. Service gross profit for the three and nine months ended September 30, 2007 and 2006 included stock-based compensation expense of \$0.6 million and \$1.6 million, and \$0.4 million and \$1.1 million, respectively.

Selling, General and Administrative Expenses

Selling, general and administrative expenses include costs for sales, marketing and administrative personnel, sales and marketing activities, tradeshow expenses, legal expenses, regulatory fees and general corporate expenses.

Selling, general and administrative expenses for the three months ended September 30, 2007 were \$40.2 million, up 41% from \$28.6 million for the three months ended September 30, 2006. Selling, general and administrative expenses for the nine months ended September 30, 2007 were \$113.0 million, up 42% from \$79.7 million for the nine months ended September 30, 2006. The increase is due to organizational growth to support our expanding business, higher commissions and other variable compensation related to higher revenue levels, increased stock-based compensation and international reorganization costs. Stock-based compensation expense charged to sales, general and administrative expenses for the three and nine month periods ended September 30, 2007 and 2006 were \$5.2 million and \$16.2 million, and \$4.4 million and \$11.7 million, respectively. Selling, general and administrative expenses are expected to increase in the future to support our expanding business.

Table of Contents***Research and Development Expenses***

Research and development costs are expensed as incurred. Research and development expenses include costs associated with the design, development, testing and enhancement of our products.

Research and development expenses for the three months ended September 30, 2007 were \$14.3 million, compared with \$8.0 million for the three months ended September 30, 2006. Research and development expenses for the nine months ended September 30, 2007 were \$32.7 million, compared with \$21.3 million for the nine months ended September 30, 2006. The increase is due to the growth in our research and development organization, higher prototype expenses, and stock-based compensation expense. Stock-based compensation expense charged to research and development expense for the three and nine months ended September 30, 2007 and 2006 were \$2.1 million and \$5.8 million, and \$1.5 million and \$3.9 million, respectively. During the second quarter of 2007, we entered into several intellectual property co-development arrangements with corporate partners. Costs associated with these co-development arrangements were \$1.8 million and \$1.9 million, respectively, for the three and nine months ended September 30, 2007. We expect to continue to make substantial investments in research and development and anticipate that research and development expenses, including the aforementioned intellectual property development arrangements, will continue to increase in the future.

Interest and Other Income, Net

Interest and other income, net, was \$12.2 million for the three months ended September 30, 2007, compared with \$3.1 million for the three months ended September 30, 2006. Interest and other income during the three months ended September 30, 2007 comprised of \$6.3 million in interest income, \$4.1 million of gain on sale of publicly-traded equity securities and \$1.8 million of foreign exchange gains. The increase in interest and other income reflects \$3.3 million from interest earned on higher cash and investment balances and higher interest rates; \$1.7 million of foreign exchange gains and \$4.1 million of gain on the sale of investments in publicly-traded equity securities.

Interest and other income, net, comprised mostly of interest income, was \$22.1 million for the nine months ended September 30, 2007, compared with \$8.6 million for the nine months ended September 30, 2006. The increase resulted from \$8.1 million of interest income earned on higher cash and investment balances and higher interest rates, \$4.1 million gain on the sale of publicly-traded equity securities and \$1.3 million of foreign exchange gains.

Income Tax Expense

Income tax expense for the three months ended September 30, 2007 was \$25.3 million, or 38.2% of pre-tax income, compared to \$11.6 million, or 40.1% of pre-tax income for the three months ended September 30, 2006. Income tax expense for the nine months ended September 30, 2007 was \$60.0 million, or 38.6% of pre-tax income, compared to \$32.1 million, or 39.9% of pre-tax income for the nine months ended September 30, 2006. The effective tax rate for the three and nine months ended September 30, 2007 differs from the U.S. federal statutory rate of 35% primarily due to state income taxes, partially offset by research and development credits generated in 2007 and domestic production deductions expected to be generated in 2007. The effective tax rate for the three and nine months ended September 30, 2006 differs from the federal statutory rate primarily due to state income taxes. We have net operating loss carryforwards and employee stock tax benefits that will be utilized in fiscal 2007. Approximately \$114 million of employee stock tax benefits have been generated in the nine-month period ended September 30, 2007. As a result, our cash outlay for taxes will be between 5% and 10% of pretax income.

Various factors may have favorable or unfavorable effects on our income tax rate. These factors include, but are not limited to, interpretations of existing tax laws, changes in tax laws and tax rates, the accounting for stock options and other share-based payments, the accounting for uncertainty in income taxes under FIN 48, mergers and acquisitions, future levels of R&D spending, changes in accounting standards, changes in the mix of earnings in the various tax jurisdictions in which we operate, changes in overall levels of pre-tax earnings, and future federal, state and foreign income tax audits. The impact on our income tax provision resulting from the above-mentioned factors may be significant and could have a negative impact on our net income.

LIQUIDITY AND CAPITAL RESOURCES***Sources and Uses of Cash***

Our principal source of liquidity is cash provided by operations and the exercise of stock options. Cash and cash equivalents plus short and long-term investments increased from \$330.3 million at December 31, 2006 to \$533.5 million at September 30, 2007. Cash generation is one of our fundamental strengths and provides us with substantial financial flexibility in meeting our operating, investing and financing needs.

Table of Contents**Consolidated Cash Flow Data**

| | Nine Months | |
|---|-----------------------------|---------------|
| | Ended September 30, 2007 | 2006 |
| | (in thousands) | |
| Net cash provided by (used in) | | |
| Operating activities | 122,675 | 71,919 |
| Investing activities | (159,609) | (54,715) |
| Financing activities | 88,756 | 30,690 |
| Effect of exchange rates on cash and cash equivalents | 181 | 43 |
| Net increase in cash and cash equivalents | 52,003 | 47,937 |

Operating Activities

For the nine months ended September 30, 2007 cash flow from operations of \$122.7 million exceeded our net income of \$95.4 million for two primary reasons:

1. Our net income included substantial non-cash charges in the form of stock-based compensation, taxes, and depreciation and amortization of long-lived assets. These non-cash charges totaled \$35.7 million during the nine months ended September 30, 2007. Also included in our net income is approximately \$4.1 million of gain on the sale of publicly-traded equity securities which has been classified as an investing activity.
2. We experienced rapid growth in our business with revenues increasing 58% during the nine months ended September 30, 2007. This growth requires investment in working capital, primarily accounts receivable and inventory. Our net investment in working capital and other operating assets totaled \$8.4 million.

Working capital is comprised of accounts receivable, inventory, other current assets, deferred revenue and other current liabilities. Accounts receivable increased by \$25.6 million or 27% during the nine months ended September 30, 2007 reflecting increased revenue and the timing of system sales. Other current assets increased by \$7.7 million or 112%, reflecting the timing of payments. Deferred revenue, which includes deferred service contract revenue that is being amortized over the service contract period, increased by \$11.2 million or 30% during 2007, which is primarily related to the increase in the number of installed systems for which service contracts exist. Other current liabilities including accounts payable, accrued compensation and employee benefits, and accrued liabilities increased \$16.1 million or 36% reflecting changes in the volume of our business and timing of vendor payments.

For the nine months ended September 30, 2006 cash flow from operations of \$71.9 million exceeded our net income of \$48.4 million for two primary reasons:

1. Our net income included substantial non-cash charges in the form of stock-based compensation, taxes, and depreciation and amortization of long-lived assets. These non-cash charges totaled \$40.4 million during the nine months ended September 30, 2006.
2. We experienced rapid growth in our business with revenues increasing 68% during the nine months ended September 30, 2006. This growth requires investment in working capital, primarily accounts receivable and inventory. Our net investment in working capital and other operating assets totaled \$16.9 million.

Investing Activities

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Net cash used in investing activities during the nine months ended September 30, 2007 and 2006 consisted primarily of purchases of investments (net of proceeds from sales and maturities of investments) of \$147.4 million and \$40.5 million, respectively, and purchases of property and equipment and licensing of patents of \$12.2 million and \$14.2 million, respectively. Our investments are in U.S. government notes and bonds, corporate notes and bonds, commercial paper and auction rate securities, and they generated approximately 5.1% interest in the first nine months of 2007. We are not a capital-intensive business. Our purchases of property and equipment during the nine months ended September 30, 2007 related mainly to facilities and information technology infrastructure to support capacity expansion in our business.

Table of Contents**Financing Activities**

Net cash provided by financing activities during the nine months ended September 30, 2007 consisted primarily of proceeds from stock options and warrants exercises of \$41.6 million and excess tax benefits from stock-based compensation of \$47.1 million. Net cash flows provided by financing activities for the nine months ended September 30, 2006 consisted primarily of proceeds from stock options and warrants exercises of \$15.8 million and excess tax benefits from stock-based compensation of \$14.8 million.

CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates are discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 and there have been no material changes other than to the income taxes policy discussed below.

Our accounting policy for income taxes was recently modified due to the adoption of FIN 48 and is described below.

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (FAS 109). This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted FIN 48 effective January 1, 2007. FIN 48 requires significant judgment in determining what constitutes an individual tax position as well as assessing the outcome of each tax position. Changes in judgment as to recognition or measurement of tax positions can materially affect the estimate of the effective tax rate and consequently, affect our operating results. Prior to the adoption of FIN 48, we recorded liabilities related to uncertain tax positions based upon Statement of Financial Accounting Standards No. 5, Accounting for Contingencies.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**Interest Rate Risk**

The primary objective of our investment activities is to preserve principal while at the same time maximizing the income we receive from our investments without significantly increasing risk. To achieve this objective, we maintain our portfolio of cash equivalents and short-term and long-term investments in a variety of securities, including government and corporate securities, commercial paper and auction rate securities. These securities are classified as available for sale and consequently are recorded on the balance sheet at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive income (loss). Our holdings of the securities of any one issuer, except government agencies, do not exceed 10% of the portfolio. If interest rates rise, the market value of our investments may decline, which could result in a realized loss if we are forced to sell an investment before its scheduled maturity. A hypothetical increase in interest rate by 25 basis points would have resulted in a decrease in the fair value of our net investment position of approximately \$0.8 million and \$0.6 million as of September 30, 2007 and December 31, 2006, respectively. We do not utilize derivative financial instruments to manage our interest rate risks.

Foreign Exchange Risk

The majority of our revenue, expense, and capital purchasing activities are transacted in U.S. dollars. However, since a portion of our operations consists of sales activities outside of the United States, we have entered into transactions in other currencies, primarily the Euro, and therefore are subject to foreign exchange risk. Our foreign operations also incur most of their expenses in the local currency.

For the three and nine months ended September 30, 2007, sales denominated in foreign currencies were 10% of total revenue. For the three months and nine months ended September 30, 2007, our revenue would have decreased by approximately \$1.7 million and \$4.3 million, respectively, if the US dollar exchange rate used would have strengthened by 10%. In addition, we have assets and liabilities denominated in foreign currencies. A 10% strengthening of the US dollar exchange rate at September 30, 2007, would have resulted in approximately \$3.3

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million decrease in the carrying amounts of those net assets.

Our international operations are subject to risks typical of international operations, including, but not limited to, differing economic conditions, changes in political climate, differing tax structures, other regulations and restrictions, and foreign exchange rate volatility. We do not utilize derivate financial instruments to manage our exchange rate risks.

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ITEM 4. CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

We maintain disclosure controls and procedures, as such term is defined in SEC Rule 13a-15(e), that are designed to ensure that information required to be disclosed in our Securities Exchange Act of 1934 reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by SEC Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal controls over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are involved in various legal proceedings and disputes that arise in the normal course of business. These matters include product liability actions, patent infringement actions, contract disputes, and other matters. We do not know whether we will prevail in these matters nor can we assure that any remedy could be reached on commercially viable terms, if at all. Based on currently available information, we believe that we have meritorious defenses to these actions and that the resolution of these cases is not likely to have a material adverse effect on our business, financial position or future results of operations. In accordance with Statement of Financial Accounting Standards, or SFAS, No. 5, Accounting for Contingencies, we record a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case.

In January 2007, the California Institute of Technology filed a patent infringement suit against our company in the United States District Court for the Eastern District of Texas. We believe the lawsuit is without merit and intend to vigorously defend our company in this matter.

ITEM 1A. RISK FACTORS

There have been no material changes in the Company's risk factors from those disclosed in the 2006 Annual Report on Form 10-K.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

| Exhibit Number | Description |
|---------------------------|--|
| 31.1 | Certification of the Company's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Company's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of the Company's Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of the Company's Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

INTUITIVE SURGICAL, INC.

(Registrant)

By: /s/ MARSHALL L. MOHR
Marshall L. Mohr
Senior Vice President and Chief Financial Officer

Date: October 19, 2007

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