INTUITIVE SURGICAL INC
Form 10-Q
October 20, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2010

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	**77-0416458**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification Number)**

1266 Kifer Road

Sunnyvale, California 94086

(Address of Principal Executive Offices) (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 such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO ¨

Indicate by check mark whether the registrant 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 x NO ¨

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

Large accelerated filer x	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 x

The Registrant had 39,293,400 shares of Common Stock, $0.001 par value per share, outstanding as of October 8, 2010.

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PART I   FINANCIAL INFORMATION

Item 1.   Financial Statements

INTUITIVE SURGICAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(IN MILLIONS, EXCEPT PAR VALUE)

(UNAUDITED)

	September 30, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 382.0	$ 221.4
Short-term investments	598.9	334.0
Accounts receivable, net	207.9	205.4
Inventory	85.0	57.6
Prepaids and other assets	20.3	20.9
Deferred tax assets	7.4	7.3
Total current assets	1,301.5	846.6
Property, plant and equipment, net	156.6	125.7
Long-term investments	639.7	616.6
Long-term deferred tax assets	65.2	53.4
Intangible assets, net	70.6	56.2
Goodwill	116.9	110.7
Other assets	1.3	0.5
Total assets	$ 2,351.8	$ 1,809.7
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 35.7	$ 27.6
Accrued compensation and employee benefits	47.2	49.8
Deferred revenue	116.8	99.4
Other accrued liabilities	67.6	26.0
Total current liabilities	267.3	202.8
Long-term liabilities	76.2	69.6
Total liabilities	343.5	272.4
Commitments and contingencies		
Stockholders equity:		
Preferred stock, 2.5 shares authorized, $0.001 par value, issuable in series; no shares issued and outstanding as of September 30, 2010 and December 31, 2009		

Common stock, 100.0 shares authorized, $0.001 par value, 39.3 and 38.5 shares issued and outstanding as of September 30, 2010 and December 31, 2009, respectively				
Additional paid-in capital		1,287.5		1,024.3
Retained earnings		720.1		511.7
Accumulated other comprehensive income		0.7		1.3
Total stockholders equity		2,008.3		1,537.3
Total liabilities and stockholders equity	$	2,351.8	$	1,809.7

See accompanying Notes to Condensed Consolidated Financial Statements.

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INTUITIVE SURGICAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)

(UNAUDITED)

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Revenue:				
Product	$ 287.1	$ 236.3	$ 860.4	$ 604.7
Service	57.3	43.8	163.3	124.4
Total revenue	344.4	280.1	1,023.7	729.1
Cost of revenue:				
Product	72.8	65.3	213.5	166.1
Service	21.0	15.8	62.3	45.1
Total cost of revenue	93.8	81.1	275.8	211.2
Gross profit	250.6	199.0	747.9	517.9
Operating expenses:				
Selling, general, and administrative	91.6	69.9	263.0	199.6
Research and development	26.9	24.6	83.4	69.3
Total operating expenses	118.5	94.5	346.4	268.9
Income from operations	132.1	104.5	401.5	249.0
Interest and other income, net	5.0	4.3	13.6	14.5
Income before taxes	137.1	108.8	415.1	263.5
Income tax expense	50.5	44.3	154.5	108.5
Net income	$ 86.6	$ 64.5	$ 260.6	$ 155.0
Earnings per share:				
Basic	$ 2.20	$ 1.69	$ 6.65	$ 4.05
Diluted	$ 2.14	$ 1.64	$ 6.45	$ 3.97
Shares used in computing earnings per share:				
Basic	39.4	38.1	39.2	38.3
Diluted	40.5	39.2	40.4	39.0

See accompanying Notes to Condensed Consolidated Financial Statements.

INTUITIVE SURGICAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN MILLIONS)

(UNAUDITED)

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Operating Activities:		
Net income	$ 260.6	$ 155.0
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	17.4	14.2
Amortization of intangible assets	12.2	11.7
Deferred income taxes	(11.8)	(15.5)
Income tax benefits from employee stock option plans	49.5	8.7
Excess tax benefit from stock-based compensation	(56.3)	(9.2)
Share-based compensation expense	87.5	71.9
Changes in operating assets and liabilities:		
Accounts receivable	(2.4)	(16.4)
Inventory	(27.4)	6.8
Prepaids and other assets	(0.3)	(6.9)
Accounts payable	8.2	4.4
Deferred revenue	17.2	12.4
Other accrued liabilities	49.7	32.3
Net cash provided by operating activities	404.1	269.4
Investing Activities:		
Purchase of investments	(1,032.2)	(523.2)
Proceeds from sales and maturities of investments	745.4	417.7
Purchase of property and equipment and acquisition of intellectual property	(86.6)	(45.7)
Net cash used in investing activities	(373.4)	(151.2)
Financing Activities:		
Proceeds from issuance of common stock, net	132.9	33.7
Excess tax benefit from stock-based compensation	56.3	9.2
Repurchase and retirement of common stock	(58.9)	(150.0)
Net cash provided by (used in) financing activities	130.3	(107.1)
Effect of exchange rate changes on cash and cash equivalents	(0.4)	0.4
Net increase in cash and cash equivalents	160.6	11.5
Cash and cash equivalents, beginning of period	221.4	194.6
Cash and cash equivalents, end of period	$ 382.0	$ 206.1

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 and its wholly-owned subsidiaries.

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 or consoles, 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. By placing computer-enhanced technology between the surgeon and the patient, the *da Vinci* Surgical System enables higher value surgical procedures to patients through increased effectiveness and reduced invasiveness.

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 have been prepared on a consistent basis with the December 31, 2009 audited Consolidated Financial Statements and include all adjustments, consisting of only normal recurring adjustments, necessary to fairly state the information set forth herein. These financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC), and, therefore, omit certain information and footnote disclosure necessary to present the statements in accordance with U.S. generally accepted accounting principles (U.S. GAAP). 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, 2009, which was filed on January 29, 2010. The results of operations for the first nine months of fiscal 2010 are not indicative of the results to be expected for the entire fiscal year or any future periods.

New Accounting Standards Recently Adopted

Revenue Recognition for Arrangements with Multiple Deliverables

The Company s revenue consists of product revenue resulting from the sales of systems, instruments and accessories, and service revenue. The Company recognizes revenue when all four revenue recognition criteria have been met: persuasive evidence of an arrangement exists; delivery has occurred or service has been rendered; the price is fixed or determinable; and collectibility is reasonably assured. The Company s revenue recognition policy generally results in revenue recognition at the following points:

System sales. For system sales directly to end customers, revenue is recognized when acceptance occurs, which is deemed to have occurred upon the receipt by the Company of a form executed by the customer acknowledging delivery and/or installation. For system sales through distributors, revenue is recognized upon transfer of title and risk of loss, which is generally at the time of shipment. Distributors do not have price protection rights. The Company s system contracts do not allow rights of return. The Company s system revenue contains a software component. Since the *da Vinci* System s software and non-software elements function together to deliver the System s essential functionality, they are considered to be one deliverable that is excluded from the software revenue recognition guidance.

Instruments and accessories. Revenue from sales of instruments and accessories is recognized when the product has been shipped. The Company records an allowance on instruments and accessories sales returns based on historical returns experience.

Service. Service contract revenue is recognized ratably over the term of the service period. Revenue related to services performed on a time-and-materials basis is recognized when it is earned and billable.

The Company determined that its multiple-element arrangements are generally comprised of the following elements that would qualify as separate units of accounting: system sales, service contracts and instruments and accessories sales.

In September 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards related to revenue recognition for arrangements with multiple deliverables and arrangements that include software elements (new accounting principles). The new accounting principles permit prospective or retrospective adoption, and the Company elected prospective adoption at the beginning of the first quarter of 2010.

For multiple-element arrangements (which are generally comprised of system sales and service contracts) entered into prior to January 1, 2010, revenue was allocated to each element based on the relative fair value of each element. Fair value is generally determined by vendor specific objective evidence (VSOE) which is based on the price charged when each element is sold separately. The Company s systems sales generally include a first year service obligation. The Company typically does not sell the systems on a stand-alone basis and therefore does not have VSOE for its systems. The Company has established VSOE for services. When the fair value of a delivered element had not been established, but fair value existed for the undelivered elements, prior to January 1, 2010, the Company used the residual method to recognize revenue. Under the residual method, the fair value of the undelivered elements was deferred and the remaining portion of the arrangement fee was allocated to the delivered elements.

Subsequent to the adoption of the new revenue accounting principles, for multiple-element arrangements entered into on or after January 1, 2010, revenue is allocated to each element based on their relative selling prices. Relative selling prices are based first on VSOE, then on third-party evidence of selling price (TPE) when VSOE does not exist, and then on estimated selling price (ESP) when VSOE and TPE do not exist.

Because the Company has neither VSOE nor TPE for its systems, the allocation of revenue has been based on the Company s ESPs. 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. The Company determines ESP for its systems by considering multiple factors including, but not limited to, features and functionality of the system, geographies, type of customer, and market conditions. The Company regularly reviews ESP and maintains internal controls over the establishment and updates of these estimates.

Had the new accounting guidance been applied to revenue at the beginning of 2009, the resultant revenue for the year ended December 31, 2009 would have been substantially the same. Had the new accounting guidance been applied to the three and nine months ended September 30, 2009, system revenue for the three months ended September 30, 2009 would have been approximately $1.5 million lower, while system revenue for the nine months ended September 30, 2009 would have been approximately $1.6 million higher.

Fair Value Measurements Disclosures

Effective January 1, 2010, the Company adopted revised guidance intended to improve disclosures related to fair value measurements, issued by FASB. This guidance requires us to separate information about significant transfers in and out of Level 1 and Level 2 and the reason for such transfers, and also requires information related to purchases, sales, issuances, and settlements information of Level 3 financial assets to be included in the rollforward of activity. The guidance also requires us to provide certain disaggregated information on the fair value of financial assets and requires us to disclose valuation techniques and inputs used for both recurring and nonrecurring fair value measurements of our Level 2 and Level 3 financial assets. The Company s policy is to recognize transfers into or out of levels as of the actual date of the event or change in circumstances that caused the transfer.

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NOTE 3. INVESTMENTS

The following tables summarize the Company s cash, cash equivalents and investments as of September 30, 2010 and December 31, 2009 (in millions):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2010				
Cash and cash equivalents:				
Cash	$ 35.0	$	$	$ 35.0
Cash equivalents	347.0			347.0
Total cash and cash equivalents	$ 382.0	$	$	$ 382.0
Available for sale investments:				
Short-term				
Commercial paper	$ 62.5	$	$	$ 62.5
Municipal notes	110.7	0.5		111.2
U.S. corporate debt	164.9	0.8		165.7
U.S. treasuries	103.3			103.3
U.S. government agencies	155.9	0.3		156.2
Total short-term	$ 597.3	$ 1.6	$	$ 598.9
Long-term				
Municipal notes	$ 109.8	$ 0.6	$ (4.3)	$ 106.1
U.S. corporate debt	327.8	4.1		331.9
U.S. treasuries	16.0	0.2		16.2
U.S. government agencies	169.0	0.6		169.6
Non-U.S. government securities	15.7	0.2		15.9
Total long-term	$ 638.3	$ 5.7	$ (4.3)	$ 639.7
Total cash, cash equivalents and available for sale investments:	$ 1,617.6	$ 7.3	$ (4.3)	$ 1,620.6

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	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2009				
Cash and cash equivalents:				
Cash	$ 28.6	$	$	$ 28.6
Cash equivalents	192.8			192.8
Total cash and cash equivalents	$ 221.4	$	$	$ 221.4
Available for sale investments:				
Short-term				
Commercial paper	$ 13.1	$	$	$ 13.1
Municipal notes	21.3	0.2		21.5
U.S. corporate debt	150.5	1.3		151.8
U.S. treasuries	31.6	0.2		31.8
U.S. government agencies	45.5	0.5		46.0
Total short-term	$ 262.0	$ 2.2	$	$ 264.2
Long-term				
Municipal notes	$ 161.0	$ 1.5	$ (4.5)	$ 158.0
U.S. corporate debt	222.5	2.1	(0.1)	224.5
U.S. treasuries	29.5		(0.2)	29.3
U.S. government agencies	204.6	0.6	(0.4)	204.8
Total long-term	$ 617.6	$ 4.2	$ (5.2)	$ 616.6
Total cash, cash equivalents and available for sale investments	$ 1,101.0	$ 6.4	$ (5.2)	$ 1,102.2
Other securities (included in short-term investments):				
Trading securities, auction rate securities	$ 62.2	$	$	$ 62.2
Put option	7.6			7.6
Total cash, cash equivalents and investments	$ 1,170.8	$ 6.4	$ (5.2)	$ 1,172.0

The following table summarizes the maturities of the Company s cash equivalents and available-for-sale investments at September 30, 2010 (in millions):

	Amortized Cost	Fair Value
Mature in less than one year	$ 944.2	$ 945.9
Mature in one to five years	615.5	621.1
Mature in more than five years	22.9	18.6
Total	$ 1,582.6	$ 1,585.6

During the three and nine months ended September 30, 2010 and 2009, realized gains or losses recognized on the sale of investments were not significant. As of September 30, 2010 and December 31, 2009, net unrealized gains on available-for-sale securities, net of tax, of $2.1 million and $0.9 million, respectively, were included in accumulated other comprehensive income in the accompanying unaudited Condensed Consolidated Balance Sheets. At September 30, 2010, the majority of the Company s gross unrealized losses were from auction-rate securities (ARS). The Company determined these unrealized losses to be temporary and recorded no other-than-temporary impairments. Factors considered in determining whether a loss is temporary included the length of time and extent to which the investments fair value has been less than the cost basis; the financial condition and near-term prospects of the investee; extent of the loss related to credit of the issuer; the expected cash flows from the security; the Company s intent to sell the security and whether or not the Company will be required to sell the security before the recovery of its amortized cost.

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NOTE 4. FAIR VALUE MEASUREMENTS

The Company measures certain financial assets including cash equivalents, available-for-sale securities, trading securities and foreign currency derivatives at their fair value. The fair value of these financial assets was determined based on three levels of inputs, of which the first two are considered observable and the last unobservable, as follows:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The following tables represent the Company s fair value hierarchy for its financial assets and liabilities as of September 30, 2010 and December 31, 2009 (in millions):

	Fair Value Measurements at September 30, 2010 Using			
Assets	**Level 1**	**Level 2**	**Level 3**	**Total**
Available-for-sale securities				
Money Market funds	$ 248.6	$	$	$ 248.6
U.S. treasuries	119.5			119.5
Commercial paper		150.8		150.8
Corporate debt		497.6		497.6
U.S. government agencies		335.9		335.9
Non-U.S. government agencies		15.9		15.9
Municipal notes		198.7	18.6	217.3
Total assets measured at fair value	$ 368.1	$ 1,198.9	$ 18.6	$ 1,585.6
Liabilities				
Foreign Currency Derivatives	$	$ 2.8	$	$ 2.8
Total liabilities measured at fair value	$	$ 2.8	$	$ 2.8

	Fair Value Measurements at December 31, 2009 Using			
Assets	**Level 1**	**Level 2**	**Level 3**	**Total**
Municipal notes - trading security	$	$	$ 62.2	$ 62.2
Put option			7.6	7.6
Available-for-sale securities				
Money Market funds	175.7			175.7
U.S. treasuries	61.1			61.1
Commercial paper		27.4		27.4
Corporate debt		379.0		379.0
U.S. government agencies		250.9		250.9

Municipal notes		160.4	19.1	179.5
Total available-for-sale securities	236.8	817.7	19.1	1,073.6
Total assets measured at fair value	$ 236.8	$ 817.7	$ 88.9	$ 1,143.4
Liabilities				
Foreign Currency Derivatives	$	$ 0.4	$	$ 0.4
Total liabilities measured at fair value	$	$ 0.4	$	$ 0.4

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

	Fair Value Measurements at Reporting Date Using Significant Unobservable Inputs (Level 3)		
	Put Option	ARS	Total
Balance at January 1, 2010	$ 7.6	$ 81.3	$ 88.9
Sales/Maturities		(8.1)	(8.1)
Total gains or (losses):			
Included in other comprehensive income (loss)		0.2	0.2
Included in earnings	(0.4)	0.4	
Balance at March 31, 2010	7.2	73.8	81.0
Sales/Maturities		(28.0)	(28.0)
Total gains or (losses):			
Included in other comprehensive income (loss)		(0.1)	(0.1)
Included in earnings	(3.2)	3.2	
Balance at June 30, 2010	$ 4.0	$ 48.9	$ 52.9
Sales/Maturities	(4.0)	(30.4)	(34.4)
Total gains or (losses):			
Included in other comprehensive income (loss)		0.1	0.1
Balance at September 30, 2010	$	$ 18.6	$ 18.6

Level 2 securities are priced using quoted market prices for similar instruments, nonbinding market prices that are corroborated by observable market data, or discounted cash flow techniques. The Company s derivative instruments are primarily classified as Level 2 as they are not actively traded and are valued using pricing models that use observable market inputs. There have been no transfers between Level 1 and Level 2 measurements during the three and nine months ended September 30, 2010, and there were no changes in the Company s valuation technique. Level 3 assets consist of municipal bonds with an auction reset feature (ARS) whose underlying assets are student loans which are substantially backed by the federal government. Since the auctions for these securities have continued to fail since February 2008, these investments are not currently trading and therefore do not have a readily determinable market value. On June 30, 2010, pursuant to the terms of the UBS rights offering, the Company exercised its right to sell all ARS subject to the rights offering to UBS at the par value of $34.4 million. As a result on July 1, 2010, the Company received the full par value in cash from UBS.

The remainder of the Company s ARS investment portfolio of $18.6 million, is reflected as long-term available-for-sale on the Company s unaudited Condensed Consolidated Balance Sheet as of September 30, 2010. The Company has valued the ARS using a discounted cash flow model based on Level 3 assumptions, including estimates of, based on data available as of September 30, 2010, interest rates, timing and amount of cash flows, credit and liquidity premiums and expected holding periods of the ARS.

Foreign currency derivative

The Company uses derivatives to partially offset its business exposure to foreign currency exchange risk. On a monthly basis, the Company enters into foreign currency forward contracts with one to seven month terms to offset some of the foreign exchange risk of expected future cash flows on certain forecasted revenue and on certain existing assets and liabilities. The Company typically hedges portions of its forecasted foreign currency exposure associated with revenue. The Company may also enter into foreign currency forward contracts to offset the foreign currency exchange gains and losses generated by re-measurement of certain assets and liabilities denominated in non-functional currencies. The hedging program is not designated for trading or speculative purposes.

The Company s accounting policies for these instruments are based on whether the instruments are designated as hedge or non-hedge instruments. The Company records all derivatives on the unaudited Condensed Consolidated Balance Sheets at fair value. The effective portions of cash flow hedges are recorded in other comprehensive income (OCI) until the hedged item is recognized in earnings. Derivative instruments designated as cash flow hedges must be de-designated as hedges when it is probable the forecasted hedged transaction will not occur in the initially identified time period or within a subsequent two month time period. Deferred gains and losses in OCI associated with such derivative instruments are reclassified immediately into earnings through interest and other income, net. Any subsequent changes in fair value of such derivative instruments also are reflected in current earnings unless they are re-designated as hedges of other transactions.

Derivatives that are not designated as hedging instruments and the ineffective portions of cash flow hedges are adjusted to fair value through earnings in interest and other income, net.

The fair value of derivative instruments in the unaudited Condensed Consolidated Balance Sheet as of September 30, 2010 and December 31, 2009 were approximately $2.8 million and $0.4 million in liabilities, respectively.

Cash Flow Hedges

The Company enters into currency forward contracts as cash flow hedges to hedge certain forecasted revenue transactions denominated in currencies other than the U.S. dollar, primarily the Euro and GBP.

As of September 30, 2010, the Company had the notional amount of 11.3 million and £0 outstanding currency forward contracts that were entered into to hedge Euro and GBP dominated sales, compared to 19.5 million and £3.9 million at December 31, 2009. The amounts reclassified to revenue as the related hedged transactions were recognized for the three and nine months ended September 30, 2010 and 2009 were not significant. Other impacts of derivative instruments designated as cash flow hedges were not significant for the three and nine months ended September 30, 2010 and 2009.

Other Derivatives Not Designated as Hedging Instruments

Other derivatives not designated as hedging instruments consist primarily of forward contracts that the Company uses to hedge intercompany balances and other monetary assets or liabilities denominated in currencies other than the U.S. dollar, primarily the Euro or GBP.

As of September 30, 2010, the Company had the notional amount of 18.7 million and £1.4 million outstanding currency forward contracts that were entered into to hedge non-functional currency denominated net monetary assets, compared to 22.0 million and £4.5 million at December 31, 2009. For the three and nine months ended September 30, 2010, the Company had recognized losses of approximately $2.3 million and gains of approximately $2.5 million, respectively, in interest and other income, net related to derivative instruments used to hedge against balance sheet foreign currency exposures. These amounts were offset by approximately $2.9 million of net foreign exchange gains and $1.9 million of net foreign exchange losses for the three and nine months ended September 30, 2010, primarily related to the re-measurement of non-functional currency denominated net monetary assets. Impacts of derivative instruments not designated as hedges were not significant for the three and nine months ended September 30, 2009.

NOTE 5. INVENTORY

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

	September 30, 2010	December 31, 2009
Inventory		
Raw materials	$ 27.4	$ 16.3
Work-in-process	2.4	2.5
Finished goods	55.2	38.8
Total	$ 85.0	$ 57.6

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NOTE 6. STOCKHOLDERS EQUITY

Comprehensive Income

The components of comprehensive income, net of tax, are as follows (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Net income	$ 86.6	$ 64.5	$ 260.6	$ 155.0
Foreign currency translation gains (losses)	0.4	0.2	(0.2)	0.3
Unrealized gains (losses) on derivative instruments, net of tax:				
Unrealized gains (losses) on derivative instruments	(2.5)	(0.6)	0.6	(1.3)
Reclassification adjustment for (gains) losses on derivative instruments recognized during the period	0.9	0.3	(2.2)	0.7
Unrealized gains (losses) on available-for-sale securities, net of tax:				
Unrealized gains arising during the period	1.2	0.6	1.2	4.5
Total other comprehensive income	$ 86.6	$ 65.0	$ 260.0	$ 159.2

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

	September 30, 2010	December 31, 2009
Foreign currency translation gains	$ 0.2	$ 0.4
Accumulated net unrealized losses on derivatives, net of tax	(1.6)	
Accumulated net unrealized gains on available-for-sale securities, net of tax	2.1	0.9
Total accumulated other comprehensive income	$ 0.7	$ 1.3

NOTE 7. STOCK-BASED COMPENSATION

Stock Option Plans

2010 Incentive Award Plan

In April 2010, the Company s stockholders approved the 2010 Incentive Award Plan (2010 Plan), which authorized approximately 1.3 million shares of common stock for issuance. Under this plan, the Company issues nonqualified stock options (NSOs) to employees and certain consultants. The 2010 Plan generally permits NSOs to be granted at no less than the fair market value of the common stock on the date of grant, with terms of 10 years from the date of grant. Options generally vest 12.5% upon completion of 6 months service and 1/48th per month thereafter; however, options may have different vesting terms as determined by the Compensation Committee. The plan expires in 2020.

A summary of stock option activity under the 2000 Equity Incentive Plan, the 2000 Non-Employee Directors Plan, the 2009 Employment Commencement Incentive Plan and the 2010 Incentive Award Plan for the nine months ended September 30, 2010 is presented as follows (in millions, except per share amounts):

	Shares Available for Grant	Stock Options Outstanding Number Outstanding	Weighted Average Exercise Price Per Share
Balance at December 31, 2009	8.9	4.6	$ 157.25
Options authorized	1.3		
Options granted	(1.3)	1.3	331.87
Options exercised		(0.9)	138.28
Options forfeited/expired (1)	(7.4)	(0.1)	222.25
Balance at September 30, 2010	1.5	4.9	$ 205.99

(1) Primarily related to the expiration of the 2000 Equity Incentive Plan.

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As of September 30, 2010, 2.3 million shares of options were exercisable at a weighted-average price of $163.81 per share.

Employee Stock Purchase Plan

Under the Employee Stock Purchase Plan (ESPP), employees purchased 61,958 shares for $6.6 million and 37,248 shares for $3.3 million during the three months ended September 30, 2010 and 2009, respectively and 144,906 shares for $14.3 million and 92,433 shares for $8.0 million during the nine months ended September 30, 2010 and 2009, respectively.

Stock-based Compensation

The following table summarizes stock-based compensation charges (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Cost of sales - products	$ 2.5	$ 2.0	$ 7.0	$ 5.7
Cost of sales - services	2.2	1.7	6.3	4.9
Total cost of sales	4.7	3.7	13.3	10.6
Selling, general and administrative	19.8	15.5	57.6	45.4
Research and development	5.9	5.4	16.6	15.9
Stock-based compensation expense before income taxes	30.4	24.6	87.5	71.9
Income tax effect	9.1	7.2	25.0	21.3
Stock-based compensation expense after income taxes	$ 21.3	$ 17.4	$ 62.5	$ 50.6

The fair value of each option grant and the fair value of the option component of the ESPP shares were estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions, assuming no expected dividends:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Stock Options				
Average risk free interest rate	1.61%	2.47%	2.28%	1.73%
Average expected term (years)	4.8	4.8	4.8	5.3
Average expected volatility	44%	46%	35%	56%
Weighted average fair value at grant date	$ 121.32	$ 87.92	$ 112.32	$ 57.11
Total stock-based compensation expense (in millions)	$ 28.1	$ 22.9	$ 81.3	$ 67.1
ESPP				
Average risk free interest rate	0.37%	0.69%	0.43%	0.63