

VARIAN MEDICAL SYSTEMS INC
Form 10-Q
May 12, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended April 3, 2015

or

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

For the transition period from _____ to _____
Commission File Number 1-7598

VARIAN MEDICAL SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	94-2359345 (I.R.S. Employer Identification Number)
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3100 Hansen Way, Palo Alto, California (Address of principal executive offices) (650) 493-4000 (Registrant's telephone number, including area code)	94304-1038 (Zip Code)
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Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large Accelerated filer	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-Accelerated filer	<input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input type="checkbox"/>

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

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 99,797,043 shares of common stock, par value \$1 per share, outstanding as of May 1, 2015.

VARIAN MEDICAL SYSTEMS, INC.
 FORM 10-Q for the Quarter Ended April 3, 2015
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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS
 (Unaudited)

(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	April 3, 2015	March 28, 2014	April 3, 2015	March 28, 2014
Revenues:				
Product	\$513,765	\$541,940	\$989,595	\$1,023,376
Service	245,641	236,566	507,665	466,632
Total revenues	759,406	778,506	1,497,260	1,490,008
Cost of revenues:				
Product	330,458	344,512	636,275	643,046
Service	106,410	105,684	211,439	209,073
Total cost of revenues	436,868	450,196	847,714	852,119
Gross margin	322,538	328,310	649,546	637,889
Operating expenses:				
Research and development	59,312	60,677	116,388	118,680
Selling, general and administrative	117,190	114,959	257,672	224,541
Litigation settlement	—	25,130	—	25,130
Total operating expenses	176,502	200,766	374,060	368,351
Operating earnings	146,036	127,544	275,486	269,538
Interest income	3,044	2,458	6,084	4,723
Interest expense	(2,001)	(1,855)	(4,046)	(3,748)
Earnings before taxes	147,079	128,147	277,524	270,513
Taxes on earnings	41,110	35,359	78,241	79,765
Net earnings	\$105,969	\$92,788	\$199,283	\$190,748
Net earnings per share - basic	\$1.06	\$0.89	\$1.99	\$1.82
Net earnings per share - diluted	\$1.05	\$0.88	\$1.97	\$1.79
Shares used in the calculation of net earnings per share:				
Weighted average shares outstanding - basic	100,157	104,152	100,315	105,038
Weighted average shares outstanding - diluted	101,026	105,446	101,341	106,414

See accompanying notes to the condensed consolidated financial statements.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS
 (Unaudited)

(In thousands)	Three Months Ended		Six Months Ended	
	April 3, 2015	March 28, 2014	April 3, 2015	March 28, 2014
Net earnings	\$ 105,969	\$ 92,788	\$ 199,283	\$ 190,748
Other comprehensive earnings (loss), net of tax:				
Defined benefit pension and post-retirement benefit plans:				
Amortization of prior service cost included in net periodic benefit cost, net of tax (expense) benefit of \$39 and \$80 for the three and six months ended April 3, 2015, respectively, and (\$6) and (\$12) for the corresponding periods of fiscal year 2014, respectively	(40	) 37	(78	) 75
Amortization of net actuarial loss included in net periodic benefit cost, net of tax expense of (\$115) and (\$231) for the three and six months ended April 3, 2015, respectively, and (\$100) and (\$201) for the corresponding periods of fiscal year 2014, respectively	505	435	1,009	870
	465	472	931	945
Unrealized gain (loss) on derivatives:				
Increase (decrease) in unrealized gain, net of tax (expense) benefit of (\$455) and (\$739) for the three and six months ended April 3, 2015, respectively, and \$419 and (\$779) for the corresponding periods of fiscal year 2014, respectively	763	(685	) 1,238	1,299
Reclassification adjustments, net of tax benefit of \$701 and \$1,027 for the three and six months ended April 3, 2015, respectively, and \$610 and \$479 for the corresponding periods of fiscal year 2014, respectively	(1,176	) (1,017	) (1,721	) (798
	(413	) (1,702	) (483	) 501
Currency translation adjustment	(18,170	) (479	) (30,460	) 990
Other comprehensive earnings (loss)	(18,118	) (1,709	) (30,012	) 2,436
Comprehensive earnings	\$ 87,851	\$ 91,079	\$ 169,271	\$ 193,184

See accompanying notes to the condensed consolidated financial statements.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Unaudited)

(In thousands, except par values)	April 3, 2015	September 26, 2014 (1)
Assets		
Current assets:		
Cash and cash equivalents	\$862,223	\$849,275
Short-term investment	70,075	66,176
Accounts receivable, net of allowance for doubtful accounts of \$26,973 at April 3, 2015 and \$20,317 at September 26, 2014	707,927	731,929
Inventories	651,779	572,261
Prepaid expenses and other current assets	177,770	148,562
Deferred tax assets	120,577	125,962
Total current assets	2,590,351	2,494,165
Property, plant and equipment, net	334,807	337,999
Goodwill	232,633	240,626
Other assets	301,745	284,500
Total assets	\$3,459,536	\$3,357,290
Liabilities and Equity		
Current liabilities:		
Accounts payable	\$164,075	\$187,377
Accrued expenses	285,377	324,409
Deferred revenues	447,755	421,845
Advance payments from customers	182,256	170,724
Product warranty	41,305	47,299
Short-term borrowings	100,000	—
Current maturities of long-term debt	50,000	50,000
Total current liabilities	1,270,768	1,201,654
Long-term debt	362,500	387,500
Other long-term liabilities	147,945	151,716
Total liabilities	1,781,213	1,740,870
Commitments and contingencies (Note 8)		
Equity:		
Varian stockholders' equity:		
Preferred stock of \$1 par value: 1,000 shares authorized; none issued and outstanding	—	—
Common stock of \$1 par value: 189,000 shares authorized; 100,201 and 100,942 shares issued and outstanding at April 3, 2015 and at September 26, 2014, respectively	100,201	100,942
Capital in excess of par value	687,348	642,848
Retained earnings	975,383	931,241
Accumulated other comprehensive loss	(88,623)	(58,611)
Total Varian stockholders' equity	1,674,309	1,616,420
Noncontrolling interest	4,014	—
Total equity	1,678,323	1,616,420
Total liabilities and equity	\$3,459,536	\$3,357,290

(1) The condensed consolidated balance sheet as of September 26, 2014 was derived from audited financial statements as of that date, but does not include all disclosures required by accounting principles generally accepted in the United

States of America.

See accompanying notes to the condensed consolidated financial statements.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Unaudited)

(In thousands)	Six Months Ended	
	April 3, 2015	March 28, 2014
Cash flows from operating activities:		
Net earnings	\$ 199,283	\$ 190,748
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Share-based compensation expense	25,238	18,640
Tax benefits from exercises of share-based payment awards	11,144	8,544
Excess tax benefits from share-based compensation	(11,138)	(8,482)
Depreciation	30,111	28,701
Amortization of intangible assets	3,286	1,938
Deferred taxes	16,399	(14,567)
Provision for doubtful accounts receivable	6,682	5,633
(Income) loss from equity investment in affiliate	(525)	600
Other, net	2,039	(1,553)
Changes in assets and liabilities, net of effects of acquisition:		
Accounts receivable	(17,457)	(99,465)
Inventories	(92,951)	(23,062)
Prepaid expenses and other assets	(20,987)	(5,354)
Accounts payable	(12,833)	(16,309)
Accrued expenses and other liabilities	(43,159)	45,074
Deferred revenues and advance payments from customers	37,134	38,027
Net cash provided by operating activities	132,266	169,113
Cash flows from investing activities:		
Purchases of property, plant and equipment	(36,722)	(43,805)
Increase in restricted cash	(35,710)	—
Investment in available-for-sale corporate debt securities	(942)	(13,746)
Notes receivable	(5,000)	(500)
Net amounts received from deferred compensation plan trust account	3,102	—
Other	104	(856)
Net cash used in investing activities	(75,168)	(58,907)
Cash flows from financing activities:		
Repurchases of common stock	(201,181)	(314,525)
Proceeds from issuance of common stock to employees	67,221	64,085
Excess tax benefits from share-based compensation	11,138	8,482
Employees' taxes withheld and paid for restricted stock and restricted stock units	(16,046)	(8,478)
Net borrowings under revolving credit facility agreements	100,000	—
Repayments under term loan facility	(25,000)	(37,500)
Capital contribution from noncontrolling interest holders	1,777	—
Other	(1,073)	(408)
Net cash used in financing activities	(63,164)	(288,344)
Effects of exchange rate changes on cash and cash equivalents	19,014	(726)
Net increase/(decrease) in cash and cash equivalents	12,948	(178,864)
Cash and cash equivalents at beginning of period	849,275	1,117,861
Cash and cash equivalents at end of period	\$ 862,223	\$ 938,997
See accompanying notes to the condensed consolidated financial statements.		

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Varian Medical Systems, Inc. (“VMS”) and its subsidiaries (collectively, the “Company”) design, manufacture, sell and service hardware and software products for treating cancer with radiotherapy, stereotactic radiosurgery, stereotactic body radiotherapy, and brachytherapy. The Company also designs, manufactures, sells and services X-ray imaging components for use in a range of applications, including radiographic or fluoroscopic imaging, mammography, specific procedures, computed tomography and industrial applications. In addition, the Company designs, manufactures, sells and services linear accelerators, image processing software and image detection products for security and inspection purposes. The Company also develops, designs, manufactures, sells and services proton therapy products and systems for cancer treatment.

Basis of Presentation

The condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and note disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements and the accompanying notes are unaudited and should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the year ended September 26, 2014 (the “2014 Annual Report”). In the opinion of management, the condensed consolidated financial statements herein include adjustments (consisting only of normal recurring adjustments) necessary for a fair statement of the Company’s financial position as of April 3, 2015 and September 26, 2014, results of operations and statements of comprehensive earnings for the three and six months ended April 3, 2015 and March 28, 2014, and cash flows for the six months ended April 3, 2015 and March 28, 2014. The results of operations for the three and six months ended April 3, 2015 are not necessarily indicative of the operating results to be expected for the full fiscal year or any future period.

Fiscal Year

The fiscal years of the Company as reported are the 52- or 53- week periods ending on the Friday nearest September 30. Fiscal year 2015 is the 53-week period ending October 2, 2015, and fiscal year 2014 was the 52-week period ended September 26, 2014. The fiscal quarters ended April 3, 2015 and March 28, 2014 were both 13-week periods.

Principles of Consolidation

The condensed consolidated financial statements include those of VMS and its subsidiaries. Intercompany balances, transactions and stock holdings have been eliminated in consolidation.

Use of Estimates

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

Recent Accounting Pronouncements or Updates Not Yet Effective

In April 2015, the Financial Accounting Standards Board (“FASB”) issued an amendment to its accounting guidance related to internal use software. The amendment clarifies that the software license element of a cloud computing arrangements should be accounted for consistent with the acquisition of other software licenses. The amendment will be effective for the Company beginning in its first quarter of fiscal year 2017. Early adoption is permitted. The amendment can be adopted either

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)
(Unaudited)

prospectively or retrospectively. The Company is evaluating the impact of adopting this guidance to its consolidated financial statements.

In April 2015, the FASB issued an amendment to its accounting guidance related to retirement benefits. The amendment provides a practical expedient that permits an entity with a fiscal year-end that does not coincide with a month-end to measure defined benefit plan assets and obligations using the month-end that is closest to the entity's fiscal year-end and apply that practical expedient consistently from year to year. The amendment also provides a practical expedient that permits an entity that has a significant event in an interim period to remeasure defined benefit plan assets and obligations using the month-end that is closest to the date of the significant event. The amendment will be effective for the Company beginning in its first quarter of fiscal year 2017 and is required to be applied on a retroactive basis. Early adoption is permitted. The amendment is not expected to have a material impact to the Company's consolidated financial statements.

In March 2015, the FASB issued an amendment to its accounting guidance related to presentation of debt issuance costs. The amendment requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. The amendment will be effective for the Company beginning in its first quarter of fiscal year 2017. Early adoption is not permitted. The amendment is required to be applied on a retroactive basis. The amendment is not expected to have a material impact to the Company's consolidated financial statements.

In February 2015, the FASB issued an amendment to its accounting guidance related to consolidation. The amendment modifies the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. The amendment will be effective for the Company beginning in its first quarter of fiscal year 2017. Early adoption is permitted. The amendment permits the use of either the retrospective or cumulative effect transition method. The amendment is not expected to have a material impact to the Company's consolidated financial statements.

In June 2014, the FASB issued an amendment to its accounting guidance related to stock-based compensation. The amendment requires that a performance target that could be achieved after the requisite service period be treated as a performance condition that affects vesting, rather than a condition that affects the grant-date fair value. The new guidance will be effective for the Company beginning in its first quarter of fiscal year 2017. Early adoption is permitted. The amendment can be applied on a prospective basis to all share-based payments granted or modified on or after the effective date. Entities will also be provided an option to apply the guidance on a modified retrospective basis to existing awards. The amendment is not expected to have a material impact to the Company's consolidated financial statements.

In May 2014, the FASB issued an amendment to its accounting guidance related to revenue recognition. The amendment sets forth a single, comprehensive revenue recognition model for all contracts with customers to improve comparability. The amendment requires revenue recognition to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The new guidance will be effective for the Company beginning in its first quarter of fiscal year 2018. Early application is not permitted. In April 2015, the FASB proposed a one-year deferral of the amendment. If the proposal is approved, the new guidance will be effective for the Company beginning in its first quarter of fiscal year 2019, with early adoption permitted, but not before the original effective date. The amendment can be applied either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the update recognized at the date of the initial application along with additional disclosures. The Company is evaluating the impact of adopting this guidance to its consolidated financial statements.

2. BALANCE SHEET COMPONENTS:

(In millions)	April 3, 2015	September 26, 2014
Available-for-sale Securities:		
Corporate debt securities:		
Amortized cost	\$80.0	\$75.6
Unrealized gain (loss)	—	—
Fair value	\$80.0	\$75.6

The available-for-sale securities represent loans to California Proton Treatment Center, LLC (“CPTC”). As of April 3, 2015, of the total amount of \$80.0 million of the available-for-sale securities, \$70.1 million is included in short-term investment and \$9.9 million is included in other assets on the Condensed Consolidated Balance Sheet. As of September 26, 2014, of the total amount of \$75.6 million of the available-for-sale securities, \$66.2 million is included in short-term investment and \$9.4 million

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES
 NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)
 (Unaudited)

is included in other assets on the Condensed Consolidated Balance Sheet. Refer to Note 15, "CPTC Loans" for additional discussion.

(In millions)	April 3, 2015	September 26, 2014
Inventories:		
Raw materials and parts	\$328.0	\$296.1
Work-in-process	136.8	124.5
Finished goods	187.0	151.7
Total inventories	\$651.8	\$572.3
(In millions)	April 3, 2015	September 26, 2014
Other long-term liabilities:		
Long-term income taxes payable	\$46.1	\$55.2
Long-term deferred income taxes	41.7	31.5
Other	60.1	65.0
Total other long-term liabilities	\$147.9	\$151.7

3. FAIR VALUE

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. There is a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

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

Level 2 — Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

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.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES
 NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)
 (Unaudited)

Assets/Liabilities Measured at Fair Value on a Recurring Basis

In the tables below, the Company has segregated all assets and liabilities that are measured at fair value on a recurring basis into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value at the measurement date.

Type of Instruments (In millions)	Fair Value Measurement Using			Total Balance
	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets at April 3, 2015:				
Available-for-sale corporate debt securities	\$—	\$—	\$80.0	\$80.0
Derivative assets	—	1.0	—	1.0
Total assets measured at fair value	\$—	\$1.0	\$80.0	\$81.0
Liabilities at April 3, 2015:				
Derivative liabilities	\$—	\$(0.2	) \$—	\$(0.2)
Contingent consideration	—	—	(6.3	) (6.3)
Total liabilities measured at fair value	\$—	\$(0.2	) \$(6.3	) \$(6.5)
Assets at September 26, 2014:				
Available-for-sale corporate debt securities	\$—			