VARIAN MEDICAL SYSTEMS INC
Form 10-Q
May 07, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 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 1-7598

VARIAN MEDICAL SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**94-2359345**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
3100 Hansen Way,	
Palo Alto, California	**94304-1030**
(Address of principal executive offices)	**(Zip Code)**

(650) 493-4000

(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 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 x 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 x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 127,469,414 shares of common stock, par value $1 per share, outstanding as of April 27, 2007.

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VARIAN MEDICAL SYSTEMS, INC.

FORM 10-Q for the Quarter Ended March 30, 2007

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

	Three Months Ended		Six Months Ended	
(In thousands, except per share amounts)	**March 30, 2007**	**March 31, 2006**	**March 30, 2007**	**March 31, 2006**
Revenues:				
Product	$ 359,359	$ 351,721	$ 677,182	$ 626,694
Service contracts and other	83,323	62,137	153,358	121,395
Total revenues	442,682	413,858	830,540	748,089
Cost of revenues:				
Product	207,542	206,337	398,475	368,082
Service contracts and other	49,971	36,436	86,746	70,158
Total cost of revenues	257,513	242,773	485,221	438,240
Gross margin	185,169	171,085	345,319	309,849
Operating expenses:				
Research and development	28,460	25,012	55,426	47,229
Selling, general and administrative	70,261	66,549	133,403	123,332
Total operating expenses	98,721	91,561	188,829	170,561
Operating earnings	86,448	79,524	156,490	139,288
Interest income	3,385	3,633	6,873	6,383
Interest expense	(1,363)	(1,099)	(2,405)	(2,183)
Earnings from operations before taxes	88,470	82,058	160,958	143,488
Taxes on earnings	27,519	26,260	50,506	46,530
Net earnings	$ 60,951	$ 55,798	$ 110,452	$ 96,958
Net earnings per share - Basic	$ 0.48	$ 0.42	$ 0.86	$ 0.74
Net earnings per share - Diluted	$ 0.46	$ 0.41	$ 0.83	$ 0.71
Weighted average shares used in the calculation of:				
Net earnings per share - Basic	128,205	131,926	128,689	131,492
Net earnings per share - Diluted	131,868	136,821	132,509	136,368

See accompanying notes to the consolidated financial statements.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except par values)	March 30, 2007	September 29, 2006 (1)
Assets		
Current assets:		
Cash and cash equivalents	$ 288,778	$ 272,508
Short-term marketable securities		93,599
Accounts receivable, net of allowance for doubtful accounts of $4,164 at March 30, 2007 and $4,473 at September 29, 2006	421,391	471,820
Inventories	267,683	189,653
Prepaid expenses and other current assets	34,326	25,953
Deferred tax assets	102,176	102,516
Total current assets	1,114,354	1,156,049
Property, plant and equipment, net	147,263	130,318
Goodwill	153,955	121,389
Other assets	125,750	103,995
Total assets	$ 1,541,322	$ 1,511,751
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 78,287	$ 77,985
Accrued expenses	256,044	265,750
Deferred revenues	92,626	117,813
Current maturities of long-term debt	7,962	7,954
Product warranty	47,518	42,992
Advance payments from customers	162,470	131,462
Total current liabilities	644,907	643,956
Long-term debt	55,916	49,356
Other long-term liabilities	25,709	21,186
Total liabilities	726,532	714,498
Commitments and contingencies (Note 8)		
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; 127,887 and 129,721 shares issued and outstanding at March 30, 2007 and at September 29, 2006, respectively	127,887	129,721
Capital in excess of par value	297,179	265,214
Retained earnings	394,255	406,849
Accumulated other comprehensive loss	(4,531)	(4,531)
Total stockholders equity	814,790	797,253
Total liabilities and stockholders equity	$ 1,541,322	$ 1,511,751

(1) The condensed consolidated balance sheet as of September 29, 2006 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 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 March 30, 2007	March 31, 2006
Cash flows from operating activities:		
Net earnings	$ 110,452	$ 96,958
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Share-based compensation expense	23,013	19,876
Tax benefits from exercises of share-based payment awards	13,430	46,061
Excess tax benefits from share-based compensation	(12,513)	(43,455)
Depreciation	12,532	11,773
Provision for doubtful accounts receivable	111	233
Loss (gain) on disposal of property, plant and equipment	55	(13)
Amortization of intangible assets	2,548	2,928
Amortization of premium/discount on marketable securities, net	29	80
Deferred taxes	(5,842)	(6,064)
Net change in fair value of derivatives and underlying commitments	(1,858)	3,877
Income on equity investment in affiliate	(28)	(1,357)
Other		72
Changes in assets and liabilities:		
Accounts receivable	75,532	(25,254)
Inventories	(60,458)	(10,705)
Prepaid expenses and other current assets	(4,129)	(7,165)
Accounts payable	(7,408)	(114)
Accrued expenses	(13,785)	(33,871)
Deferred revenues	(25,187)	4,182
Product warranty	3,880	74
Advance payments from customers	13,542	13,008
Other long-term liabilities	523	(579)
Net cash provided by operating activities	124,439	70,545
Cash flows from investing activities:		
Proceeds from maturities or sale of marketable securities	193,470	46,665
Purchases of marketable securities	(99,900)	(35,000)
Acquisition of business, net of cash acquired	(26,792)	
Purchases of property, plant and equipment	(25,387)	(17,371)
Equity investment in affiliate	(10,915)	(2,980)
Increase in cash surrender value of life insurance	(4,155)	(3,541)
Note receivable from affiliate and other	616	(151)
Proceeds from disposal of property, plant and equipment	656	340
Other, net	(1,932)	(90)
Net cash provided by (used in) investing activities	25,661	(12,128)
Cash flows from financing activities:		
Repurchases of common stock	(152,911)	(123,836)
Proceeds from issuance of common stock to employees	23,590	52,639
Excess tax benefits from share-based compensation	12,513	43,455
Employees taxes withheld and paid for restricted performance shares and restricted stock	(63)	(8,077)

Repayment of mandatorily redeemable financial instrument	(11,771)	
Repayments of bank borrowings	(100)	(100)
Net cash used in financing activities	(128,742)	(35,919)
Effects of exchange rate changes on cash and cash equivalents	(5,088)	681
Net increase in cash and cash equivalents	16,270	23,179
Cash and cash equivalents at beginning of period	272,508	243,086
Cash and cash equivalents at end of period	$ 288,778	$ 266,265

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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 subsidiaries (collectively, the Company) designs, manufactures, sells and services advanced equipment and software products for treating cancer with radiation. The Company also designs, manufactures, sells and services high quality, cost-effective X-ray tubes for original equipment manufacturers; replacement X-ray tubes; flat panel digital image detectors for filmless X-rays (commonly referred to as flat panel detectors or digital image detectors) for medical, scientific and industrial applications; linear accelerators for security and inspection purposes; and proton therapy systems for cancer treatment and scientific instruments used in particle research.

Fiscal Year

The Company s fiscal year is the 52- or 53-week period ending on the Friday nearest September 30. Fiscal year 2007 is the 52-week period ending September 28, 2007, and fiscal year 2006 was the 52-week period ended September 29, 2006. The fiscal quarters ended March 30, 2007 and March 31, 2006 were both 13-week periods.

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 financial statements prepared in accordance with generally accepted accounting principles 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 29, 2006. In the opinion of management, the condensed consolidated financial statements herein include adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Company s financial position as of March 30, 2007 and September 29, 2006, results of operations for the three and six months ended March 30, 2007 and March 31, 2006, and cash flows for the six months ended March 30, 2007 and March 31, 2006. The results of operations for the three and six months ended March 30, 2007 are not necessarily indicative of the operating results to be expected for the full fiscal year or any future periods.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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.

Goodwill and Intangible Assets

The Company evaluates goodwill and purchased assets with indefinite lives for impairment annually in accordance with Statement of Financial Accounting Standards (SFAS) No. 142 Goodwill and Other Intangible Assets (SFAS 142). The impairment test for goodwill is a two-step process. Step one consists of a comparison of the fair value of a reporting unit with its carrying amount, including the goodwill allocated to each reporting unit. The Company determines the fair value of its reporting units based on the present value of estimated future cash flows of the reporting units. The reporting units are consistent with the reportable operating segments identified in Note 14 Segment Information . If the carrying amount is in excess of the fair value, step two requires the comparison of the implied fair value of the reporting unit with the carrying amount of the reporting unit s goodwill. Any excess of the carrying value of the reporting unit s goodwill over the implied fair value of the reporting unit s goodwill is recorded as an impairment loss. We performed such evaluations for the two reporting units that carried goodwill in the fourth quarter of fiscal year 2006, Oncology Systems and X-ray Products, and found no impairment. The impairment test for intangible assets with indefinite useful lives, if any, consists of a comparison of fair value to carrying value, with any excess of carrying value over fair value being recorded as an impairment loss.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Purchased intangible assets are carried at cost, net of accumulated amortization. Intangible assets with finite lives are amortized over their estimated useful lives of approximately two to twenty years using the straight-line method.

Revenue Recognition

The Company s revenues are derived primarily from hardware and software products sales and contract services of Oncology Systems products, X-ray products, Security and Inspection products, proton therapy contracts and scientific instruments contracts.

Hardware Products

The Company recognizes revenues for hardware products in accordance with Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition* (SAB 104) when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable and collectibility is reasonably assured. For an arrangement with multiple deliverables, the Company recognizes product sales in accordance with Emerging Issues Task Force No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF 00-21) with revenues allocated among the different elements. The Company typically requires its customers to provide a down payment prior to transfer of risk of loss of ordered products or prior to performance under service contracts. These down payments are recorded as Advance payments from customers in the Condensed Consolidated Balance Sheets.

For Oncology Systems and Security and Inspection hardware products with installation obligations, the Company recognizes as revenues a portion of the product purchase price upon transfer of risk of loss and defers revenue recognition on the portion associated with product installation until acceptance, provided that all other criteria for revenue recognition under SAB 104 and EITF 00-21 are met. The portion deferred is the greater of the fair market value of the installation services for such products or the amount of payment contractually linked to the acceptance. However, when (a) all of the purchase price for the hardware product is conditioned upon acceptance, (b) the hardware product does not have value to the customer on a standalone basis, or (c) there is no objective and reliable evidence of the fair value of the undelivered item, the Company defers all revenues until acceptance in accordance with the treatment for delivered items under EITF 00-21.

Installation of Oncology Systems and Security and Inspection hardware products involves the Company s testing of each product at its factory prior to delivery of such product to ensure that the product meets the Company s published specifications. Once these tests establish that the specifications have been met, the product is then disassembled and shipped to the customer s site as specified in the customer contract. Risk of loss is transferred to the customer either at the time of shipment or delivery, depending upon the shipping terms of the contract. At the customer s site, the product is reassembled, installed and retested in accordance with the Company s installation procedures to ensure and demonstrate compliance with the Company s published specifications for such product.

Under the terms of the Company s hardware sales contract, acceptance of a hardware product with installation obligations is deemed to have occurred upon the earliest of (i) completion of product installation and testing in accordance with the Company s standard installation procedures showing compliance with the Company s published specifications for that product, (ii) receipt by the Company of an acceptance form executed by the customer acknowledging installation and compliance with the Company s published specification for that product, (iii) use by the customer of the product for any purpose after its delivery or (iv) six months after the delivery of the product to the customer by the Company. The contract allows for cancellation only by mutual agreement, thus the customer does not have a unilateral right to return the delivered hardware product.

The Company does not have installation obligations for X-ray tubes, digital image detectors, spare parts and certain hardware products in Oncology Systems and Security and Inspection Products (SIP) business. For the products that do not include installation obligations, the Company recognizes revenues upon the transfer of risk of loss, which is either at the time of shipment or delivery, depending upon the shipping terms of the contract, provided that all other criteria under SAB 104 and EITF 00-21 are met.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Software Products

The Company recognizes revenues for software products in accordance with Statement of Position (SOP) No. 97-2, *Software Revenue Recognition* (SOP 97-2), as amended by SOP No. 98-9, *Software Revenue Recognition with Respect to Certain Agreements*. The Company recognizes license revenues when all of the following criteria are met: persuasive evidence of an arrangement exists, the vendor s fee is fixed or determinable, collection of the related receivable is probable, delivery of the product has occurred and the Company has received from the customer an acceptance form acknowledging installation and substantial conformance with the Company s specifications (as set forth in the user manual) for such product, or upon verification of installation when customer acceptance is not required to be received, provided that all other criteria for revenue recognition under SOP 97-2 have been met. Revenues earned on software arrangements involving multiple elements are allocated to each element based on vendor-specific objective evidence of the fair value (VSOE), which is based on the price charged when the same element is sold separately. In instances when evidence of VSOE of all undelivered elements exists, but evidence does not exist for one or more delivered elements, revenues are recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. Revenue allocated to maintenance and support is recognized ratably over the maintenance term (typically one year).

Installation of the Company s software products involves a certain amount of customer-specific implementation to enable the software product to function within the customer s operating environment (*i.e.*, with the customer s information technology network and other hardware, with the customer s data interfaces and with the customer s administrative processes) and substantially in conformance with the Company s specifications (as set forth in the user manual) for such product. With the Company s software products, customers do not have full use of the software (*i.e.*, functionality) until the software is installed as described above and functioning within the customer s operating environment. Therefore, the Company recognizes 100% of software revenues upon receipt from the customer of the Company s acceptance form acknowledging installation and such substantial conformance, or upon verification of installation when the Company is not required to receive customer acceptance, or upon the expiration of an acceptance period, provided that all other criteria for revenue recognition under SOP 97-2 have been met.

Other

Revenues related to service contracts are recognized ratably over the period of the related contracts. Revenues related to services performed on a time-and-materials basis are recognized when it is earned and billable.

Revenues related to certain contracts for proton therapy and scientific instruments products and services are recognized using the percentage-of-completion method in accordance with SOP 81-1, *Accounting for Performance of Construction-Type and Certain Product Type Contracts*. Revenues recognized under the percentage-of-completion method are primarily based on contract costs incurred to date compared with total estimated contract costs. Estimated losses on contracts are charged to cost of sales in the period the loss is identified.

Recent Accounting Pronouncements

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (SFAS 109). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109. This interpretation will be effective for the Company in the first quarter of fiscal year 2008. The Company is evaluating the impact of the adoption of this interpretation on the Company s consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact that SFAS 157 may have on its consolidated financial position, results of operations and cash flows.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

In September 2006, the FASB issued SFAS No. 158, *Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R)* (SFAS 158). SFAS 158 requires the Company to (a) recognize a plan s funded status in its statement of financial position, (b) measure a plan s assets and its obligations that determine the plan s funded status as of the end of the employer s fiscal year and (c) recognize changes in the funded status of a defined postretirement plan in the year in which the changes occur through other comprehensive income. The requirement to recognize the funded status of a defined benefit plan and the disclosure requirements are effective for the Company s fiscal year ending September 28, 2007. Based on the funded status of the Company s plan obligations disclosed in Note 9 of the Notes to the Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the fiscal year ended September 29, 2006, the estimated impact of adopting SFAS 158 would have been a decrease in total assets at September 29, 2006 of approximately $3 million, an increase in total liabilities of approximately $18 million and a reduction in stockholders equity of approximately $21 million, excluding the impact of taxes. There would have been no impact on the Company s fiscal year 2006 Consolidated Statements of Earnings or Cash Flows. The actual impact of the implementation of SFAS 158 on the fiscal year 2007 financial statements will differ from that estimate due to changes in economic assumptions such as discount rates, measurement of fair values of plan assets, and other changes in actuarial assumptions that will occur in connection with the next measurement date on September 28, 2007.

In September 2006, the SEC issued SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108), to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires the quantification of misstatements based on their impact on both the balance sheet and the income statement to determine materiality. The guidance provides for a one-time cumulative effect adjustment to correct for misstatements that were not deemed material under a company s prior approach but are material under the SAB 108 approach. SAB 108 will be effective for the Company s fourth quarter of fiscal year ending September 28, 2007. The Company is assessing the potential impact that SAB 108 may have on its consolidated financial position, results of operations and cash flows. However, based on the evaluation to date, the Company believes there will be no impact at adoption on its financial statements or related disclosures.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities -Including an Amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS 159 is effective for the Company beginning in the first quarter of 2009. The Company is currently assessing the impact SFAS 159 may have on its consolidated financial position, results of operations and cash flows.

Reclassifications

Certain financial statement items have been reclassified to conform to the current year s format. These reclassifications had no impact on previously reported net earnings.

2. MARKETABLE SECURITIES

At March 30, 2007, the Company did not have any marketable securities. At September 29, 2006, the carrying amounts of marketable securities, which were all municipal securities, were reflected as follows:

(In millions)	September 29, 2006
Short-term marketable securities	$ 93.6
Marketable securities classified as:	
Available-for-sale	$ 90.0
Held-to-maturity	3.6

	$ 93.6

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

3. INVENTORIES

The components of inventories are as follows:

(In millions)	March 30, 2007	September 29, 2006
Raw materials and parts	$ 130.7	$ 108.5
Work-in-progress	32.9	14.4
Finished goods	104.1	66.8
Total inventories	$ 267.7	$ 189.7

4. GOODWILL AND INTANGIBLE ASSETS

The following table reflects the gross carrying amount and accumulated amortization of the Company s intangible assets included in Other assets on the Condensed Consolidated Balance Sheets as follows:

(In millions)	March 30, 2007	September 29, 2006
Intangible Assets:		
Acquired existing technology	$ 18.9	$ 14.1
Patents, licenses and other	14.0	13.9
Customer contracts and supplier relationships	10.1	10.1
Accumulated amortization	(26.8)	(24.3)
Net carrying amount	$ 16.2	$ 13.8

The increase in gross carrying amount of intangibles assets was due to the January 2007 acquisition of ACCEL Instruments GmbH (ACCEL), which is included in Other . Amortization expense for intangible assets required to be amortized under SFAS 142 was $1.3 million and $1.4 million for the three months ended March 30, 2007 and March 31, 2006 and $2.6 million and $2.9 million for the six months ended March 30, 2007 and March 31, 2006, respectively. At March 30, 2007, the Company estimates amortization expense on a straight-line basis for the remaining six months of fiscal year 2007, fiscal years 2008 through 2011, and thereafter, to be as follows (in millions): $2.5, $3.8, $3.1, $2.6, $2.0 and $2.2.

The following table reflects the allocation of goodwill:

(In millions)	March 30, 2007	September 29, 2006
Oncology Systems	$ 125.0	$ 120.9
X-ray Products	0.5	0.5
Other	28.5	

Total	$ 154.0	$ 121.4

The increase in the carrying amount of goodwill was due to the acquisition of ACCEL and the adjustment to the purchase price of the radiotherapy equipment service business of Mitsubishi Electric Co. (MELCO) in Japan and certain other Asian and South American countries (the Service Business) related to the earn out payment. See Note 13 Business Combination for a discussion of the acquisition of ACCEL and Note 8 Commitments and Contingencies for a discussion of the adjustment to the purchase price of the Service Business.

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

5. RELATED PARTY TRANSACTIONS

In fiscal years 1999 and 2000, VMS invested a total of $5 million in a three member consortium for a 20% ownership interest in dpiX Holding LLC (dpiX Holding), which in turn invested $25 million for an 80.1% ownership interest in dpiX LLC (dpiX), a supplier of amorphous silicon based thin-film transistor arrays (flat panels) for the Company s X-ray Products digital imaging subsystems and for its Oncology Systems On-Board Imager and PortalVision imaging systems. The Company purchased flat panels from dpiX totaling $4.6 million for the three months ended March 30, 2007 and $2.8 million for the three months ended March 31, 2006. Flat panels purchased from dpiX totaled $11.1 million for the six months ended March 30, 2007 and $7.3 million for the six months ended March 31, 2006. These purchases of flat panels are included as a component of Inventory in the Condensed Consolidated Balance Sheets and Cost of revenues - product in the Condensed Consolidated Statements of Earnings. VMS had the right to appoint one manager of the five person board of managers and the investment was accounted for under the equity method. In accordance with the dpiX Holding agreement, net losses were to be allocated to the other two members, in succession, until their capital accounts equaled zero, before being allocated to VMS. The dpiX Holding agreement also provided that net profits were to be allocated to the other two members, in succession, until their capital accounts equaled the net losses previously allocated, then to the three members in accordance with their ownership interests.

In September 2004, VMS acquired another member s entire 20% ownership interest in dpiX Holding for $1 million. As a result, VMS has the right to appoint two managers of the five person board of managers and its ownership interest in dpiX Holding increased to 40% with the remaining 60% being held by the other original member. When VMS acquired this additional 20% ownership interest, the capital account of the selling member was nearly zero because it was the first in the consortium to be allocated losses. However, dpiX Holding has been profitable since VMS acquired the additional 20% ownership interest. As a result, VMS was the first to be allocated net profits to recover previously allocated losses and recorded in the three months ended March 30, 2007 and March 31, 2006 income on the equity investment in dpiX Holding of $11,000 and $512,000, respectively, and in the six months ended March 30, 2007 and March 31, 2006 of $28,000 and $1,357,000, respectively, which is included in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings.

In accordance with the dpiX agreement, the member that owns the other 19.9% ownership interest in dpiX had the right to sell back to dpiX on dpiX s last business day in December 2004, 2005 and 2006, cumulatively all of that member s ownership interest for $5 million if dpiX had not become a publicly traded company as of the last business day in December 2004. In December 2004, that member exercised its right to sell back to dpiX its 19.9% ownership interest. On each of December 22, 2005 and December 24, 2004, dpiX repurchased from that member a 7.96% ownership interest for a payment of $2 million (in aggregate, a 15.92% interest for $4 million). On December 22, 2006, dpiX repurchased the remaining 3.98% ownership interest for $1 million and VMS s indirect ownership interest in dpiX increased to 40%.

In December 2004, VMS agreed to loan $2 million to dpiX in four separate installments, bearing interest at prime rate plus 1% per annum. The principal balance is due and payable to VMS in twelve equal quarterly installments that began in October 2006; interest is payable in full according to the same quarterly schedule, but began in April 2005; and the entire principal balance, together with accrued and unpaid interest thereon and all other related amounts payable hereunder, is fully due and payable on July 10, 2009. The note receivable from dpiX totaled $1.7 million and $2 million at March 30, 2007 and September 29, 2006, respectively, and is primarily included in Other Assets in the Condensed Consolidated Balance Sheet.

In March 2006, VMS and the other member of dpiX Holding agreed in principle to invest an aggregate of $92 million in dpiX Holding for dpiX to acquire and construct a manufacturing facility in Colorado to increase its production capacity. The members contributions for this facility are based on their percentage of ownership interest in dpiX Holding. As of March 30, 2007, VMS had contributed to dpiX Holding approximately $23.2 million, which is included in Other assets. VMS expects to invest an additional $13.6 million in dpiX Holding over the next five months.

6. PRODUCT WARRANTY

The Company provides for estimated future costs of warranty obligations in accordance with FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* which requires an entity to disclose and recognize a liability for the fair value of the obligation it assumes upon issuance of a guarantee. The Company warrants most of its

products for a specific period of time, usually one year, against material defects. The Company provides for the estimated future costs of warranty obligations in cost of revenues when the

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VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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related revenues are recognized. The accrued warranty costs represent the best estimate at the time of sale of the total costs that the Company will incur to repair or replace product parts that fail while still under warranty. The amount of accrued estimated warranty costs obligation for established products is primarily based on historical experience as to product failures adjusted for current information on repair costs. For new products, estimates include the historical experience of similar products, as well as reasonable allowance for start-up expenses. On a quarterly basis, the Company reviews the accrued warranty costs and updates the historical warranty cost trends.

The following table reflects the change in the Company s accrued product warranty during the six months ended March 30, 2007 and March 31, 2006:

	Six Months Ended	
(In millions)	**March 30, 2007**	**March 31, 2006**
Accrued product warranty, at beginning of period	$ 43.0	$ 39.4
Charged to cost of revenues	23.4	18.6
Actual product warranty expenditures	(18.9)	(18.6)
Accrued product warranty, at end of period	$ 47.5	$ 39.4

7. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company has significant transactions denominated in foreign currencies and addresses certain financial exposures through a program of risk management that includes the use of derivative financial instruments. The Company sells products throughout the world, often in the currency of the customer s country, and typically hedges many of these firmly committed foreign currency sales orders. These firmly committed foreign currency sales orders are hedged using forward exchange contracts. The Company enters into foreign currency forward exchange contracts primarily to reduce the effects of fluctuating foreign currency exchange rates. The Company does not enter into forward exchange contracts for speculative or trading purposes. The forward exchange contracts range from one to twelve months in maturity. As of March 30, 2007, the Company did not have any forward exchange contracts with an original maturity greater than twelve months. As international deliveries may extend beyond twelve months, the Company may hedge beyond twelve months in the future.

The Company accounts for its hedges of foreign currency denominated sales orders (firm commitments) as fair value hedges as prescribed by SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 149, *Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities* (SFAS 133). For the three and six months ended March 30, 2007, there were no material gains or losses due to hedge ineffectiveness. At March 30, 2007, the Company had foreign exchange forward contracts for fair value hedges with notional values to sell and purchase $244.0 million and $11.4 million, respectively, in various foreign currencies. At March 30, 2007, all open forward exchange contracts were deemed effective.

The Company also hedges balance sheet exposures from its various foreign subsidiaries and business units. The Company enters into monthly foreign currency forward exchange contracts to minimize the short-term impact of foreign currency fluctuations on assets and liabilities denominated in currencies other than the U.S. dollar functional currency. These hedges of foreign-currency-denominated assets and liabilities do not qualify for hedge accounting treatment under SFAS 133. For derivative instruments not designated as hedging instruments, changes in their fair values are recognized in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings.

Changes in the values of these hedging instruments are offset by changes in the values of foreign currency denominated assets and liabilities. Variations from the forecasted foreign currency assets or liabilities, coupled with a significant currency movement, may result in a material gain or loss if the hedges are not effectively offsetting the change in value of the foreign currency asset or liability.

Other than foreign exchange hedging activities, the Company has no other freestanding or embedded derivative instruments.

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8. COMMITMENTS AND CONTINGENCIES

Commitments

Following a decision by MELCO to exit the radiotherapy equipment and service business and its desire to do so in a nondisruptive manner with an established radiotherapy equipment service provider, the Company entered into two separate transactions with MELCO contemporaneously whereby (i) the Company purchased the Service Business to service MELCO s existing customers and (ii) the Company formed a three-year joint venture (JVA) in Japan with MELCO that was effective as of February 3, 2004.

On February 2, 2004, the Company s Japanese subsidiary (VMS KK) purchased the Service Business for 2.0 billion Japanese Yen, or US$19.1 million, plus a contingent earn out payable to MELCO at the end of the three-year JVA period. This earn out payment is equivalent to 100% of the net profits or losses of the Service Business for the three-year period. The Company accounted for the purchase of the Service Business as an acquisition and 100% of the profits and losses from VMS KK are reflected in the Company s consolidated results. The Company accounted for the earn out payment equivalent to 100% of the net profits or losses of the Service Business during the three-year period as an adjustment to the purchase price of the acquisition at the end of the period. For the period from February 2, 2004 to February 2, 2007, net profits for the Service Business totaled approximately $4.1 million, which was recorded as an adjustment to goodwill in the second quarter of fiscal year 2007. The Company expects to make the earn out payment to MELCO in the third quarter of fiscal year 2007.

In addition to purchasing the Service Business, the Company entered into a distributor arrangement with MELCO to sell MELCO radiotherapy equipment products through VMS KK for two years. During that two-year period ended February 2, 2006, the Company did not sell any MELCO radiotherapy equipment products.

The JVA was accomplished through MELCO s purchase on February 3, 2004 of a 35% ownership interest in VMS KK for 1.4 billion Japanese Yen, or US$13.5 million. During the three-year JVA period, MELCO was not entitled to any profits or losses generated by VMS KK. However, MELCO was entitled to elect one of the five members of VMS KK s board of directors. At the end of the three-year JVA period, MELCO was required to unconditionally sell and the Company was required to unconditionally repurchase MELCO s 35% ownership interest in VMS KK at the original sale price (1.4 billion Japanese Yen) and there were no settlement alternatives to such a repurchase obligation. The Company accounted for MELCO s 35% ownership interest as a mandatorily redeemable financial instrument, which was included in Accrued expenses in the Condensed Consolidated Balance Sheets. On February 2, 2007, the Company repurchased the 35% ownership interest in the JVA from MELCO for 1.4 billion Japanese Yen, or US$11.8 million.

Contingencies

The U.S. Environmental Protection Agency (EPA) or third parties have named the Company as a potentially responsible party (PRP) under the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended (CERCLA), at eight sites where the Company, as Varian Associates, Inc., is alleged to have shipped manufacturing waste for recycling or disposal, and as a PRP the Company may have an obligation to reimburse the EPA or other third parties for cleanup costs at these sites. In addition, the Company is overseeing environmental cleanup projects and, as applicable, reimbursing third parties for cleanup activities under the direction of, or in consultation with, federal, state and/or local agencies at certain current VMS or former Varian Associates, Inc. facilities (including facilities disposed of in connection with the Company s sale of its Electron Devices business during 1995 and the sale of its thin film systems business during 1997). Under the terms of the agreement governing the spin-offs of Varian, Inc. (VI) and Varian Semiconductor Equipment Associates, Inc. (VSEA), by the Company in 1999, VI and VSEA are each obligated to indemnify the Company for one-third of these environmental cleanup costs (after adjusting for any insurance proceeds realized or tax benefits recognized by the Company). The Company spent $0.3 million and $0.2 million (net of amounts borne by VI and VSEA) during the three months ended March 30, 2007 and March 31, 2006, respectively, on environmental cleanup costs, third-party claim costs, project management costs and legal costs. The Company spent $0.5 million and $0.6 million (net of amounts borne by VI and VSEA) during the six months ended March 30, 2007 and March 31, 2006, respectively, on environmental cleanup costs, third-party claim costs, project management costs and legal costs.

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Various uncertainties make it difficult to estimate the likelihood or cost of certain third-party claims, project management costs and legal costs at all of the sites and facilities. In addition, for the eight sites and one of the facilities, various uncertainties make it difficult to assess the likelihood and scope of further cleanup activities or to estimate the future cost of such activities. As of March 30, 2007, the Company nonetheless estimated that the Company s future exposure (net of VI s and VSEA s indemnification obligations) for the cleanup costs, third party-claims, project management costs and legal costs for these nine locations ranged in the aggregate from $3.6 million to $7.2 million. The time frames over which these cleanup project costs are estimated vary ranging from one year up to 14 years as of March 30, 2007. Management believes that no amount in the foregoing range of estimated future costs is more probable of being incurred than any other amount in such range and therefore accrued $3.6 million for these cleanup projects as of March 30, 2007. The amount accrued has not been discounted to present value due to the uncertainties that make it difficult to develop a best estimate of future costs.

As to all other facilities, the Company has gained sufficient knowledge to better estimate the scope and costs of future cleanup activities based upon formal agreements with other parties defining the Company s future liabilities or formal cleanup plans that have either been approved by or completed in accordance with the requirements of the state or federal environmental agency with jurisdiction over the facility. As of March 30, 2007, the Company estimated that the Company s future exposure (net of VI s and VSEA s indemnification obligations) for the cleanup costs at these facilities, and reimbursements of third party s claims for these facilities, ranged in the aggregate from $9.4 million to $36.0 million. The time frames over which these cleanup project costs are estimated vary, ranging from 2 years to 30 years as of March 30, 2007. As to each of these facilities, management determined that a particular amount within the range of estimated costs was a better estimate of the future environmental liability than any other amount within the range, and that the amount and timing of these future costs were reliably determinable. The best estimate within the range was $17.3 million at March 30, 2007. The Company accordingly accrued $11.7 million, which represents its best estimate of the future costs of $17.3 million discounted at 4%, net of inflation. This accrual is in addition to the $3.6 million described in the preceding paragraph.

The foregoing amounts are only estimates of anticipated future environmental-related costs to cover the known cleanup projects, and the amounts actually spent may be greater or less than such estimates. The aggregate range of cost estimates reflects various uncertainties inherent in many environmental cleanup activities, the large number of sites and facilities involved and the amount of third-party claims. The Company believes that most of these cost ranges will narrow as cleanup activities progress. The Company believes that its reserves are adequate, but as the scope of its obligations becomes more clearly defined, these reserves (and the associated indemnification obligations of VI and VSEA) may be modified and related charges/credits against earnings may be made.

Although any ultimate liability arising from environmental-related matters described herein could result in significant expenditures that, if aggregated and assumed to occur within a single fiscal year would be material to the Company s consolidated financial statements, the likelihood of such occurrence is considered remote. Based on information currently available to management and its best assessment of the ultimate amount and timing of environmental-related events (and assuming VI and VSEA satisfy their indemnification obligations), management believes that the costs of these environmental-related matters are not reasonably likely to have a material adverse effect on the consolidated financial statements of the Company in any fiscal year.

The Company evaluates its liability for environmental-related investigation and cleanup costs in light of the liability and financial strength of potentially responsible parties and insurance companies with respect to which the Company believes that it has rights to contribution, indemnity and/or reimbursement (in addition to the obligations of VI and VSEA). Claims for recovery of environmental investigation and cleanup costs already incurred, and to be incurred in the future, have been asserted against various insurance companies and other third parties. The Company receives certain cash payments in the form of settlements and judgments from defendants, its insurers and other third parties from time to time. The Company has also reached an agreement with another insurance company under which the insurance company has agreed to pay a portion of the Company s past and future environmental-related expenditures, and the Company therefore recorded a $2.8 million receivable at March 30, 2007, which was included in Other assets . The Company believes that this receivable is recoverable because it is based on a binding, written settlement agreement with a solvent and financially viable insurance company and the insurance company has in the past paid the claims that the Company has made.

The Company is also involved in other legal proceedings arising in the ordinary course of its business. While there can be no assurances as to the ultimate outcome of any litigation involving the Company, management does not believe any pending legal proceeding will result in a judgment or settlement that would have a material adverse effect on the Company s consolidated financial position, results of operations or cash flows.

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(Unaudited)

9. RETIREMENT PLANS

The Company s net defined benefit and post-retirement benefit costs were composed of the following:

	Three Months Ended		Six Months Ended	
(In thousands)	March 30, 2007	March 31, 2006	March 30, 2007	March 31, 2006
Defined Benefit Plans				
Service cost	$ 1,219	$ 929	$ 2,404	$ 1,858
Interest cost	1,063	844	2,106	1,688
Expected return on plan assets	(1,126)	(841)	(2,253)	(1,682)
Amortization of transition amount		(2)		(4)
Amortization of prior service cost	30	32	61	64
Recognized actuarial loss	235	213	471	426
Net pension benefit cost	$ 1,421	$ 1,175	$ 2,789	$ 2,350
Post-Retirement Benefit Plans				
Interest cost	94	71	188	142
Amortization of transition amount	123	123	246	246
Amortization of prior service cost	1	1	2	2
Recognized actuarial (gain)/loss	6	(1)	11	(2)
Net pension benefit cost	$ 224	$ 194	$ 447	$ 388

The Company made contributions to the defined benefit plans of $3.6 million during the six months ended March 30, 2007. The Company currently expects total contributions to the defined benefit plans for fiscal year 2007 will be approximately $12.6 million. The Company made contributions to the post-retirement benefit plans of $0.3 million during the six months ended March 30, 2007. The Company currently expects total contributions to the post-retirement benefit plans for fiscal year 2007 will be approximately $0.5 million.

10. STOCKHOLDERS EQUITY

Stock Repurchase Program

On November 20, 2006, the Company announced that its Board of Directors had approved the repurchase of 4,500,000 shares of VMS common stock over the period through September 28, 2007 in addition to the 1,500,000 shares of common stock that had been available for repurchase as of September 29, 2006 under the prior program. During the six months ended March 30, 2007, the Company paid $152.9 million to repurchase 3,100,000 shares of VMS common stock, of which $76.3 million was paid during the three months ended March 30, 2007 to repurchase 1,600,000 shares. All shares that have been repurchased have been retired. As of March 30, 2007, the Company could repurchase up to 2,900,000 shares of VMS common stock under the November 20, 2006 authorization.

Comprehensive Earnings

Comprehensive earnings for the three and six months ended March 30, 2007 and March 31, 2006 equaled the reported net earnings.

11. EMPLOYEE STOCK PLANS

In February 2007, VMS s stockholders approved the Second Amended and Restated 2005 Omnibus Stock Plan (the Second Amended 2005 Plan), which modified the Amended and Restated 2005 Omnibus Stock Plan (the Amended 2005 Plan) to (i) increase the number of shares available for grant under the plan by 2,650,000 shares, (ii) explicitly prohibit the repricing of stock options and stock appreciation rights without the approval of VMS s stockholders, (iii) change the number of shares counted against the available-for-grant limit from three shares to 2.5 shares for every one share issued in connection with

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awards other than stock options and stock appreciation rights, (iv) change the expiration date of stock options from a maximum of ten years to a maximum of seven years from the date of grant (v) cease to increase the number of shares available for grant under the plan by the number of shares tendered to VMS as payment for the exercise of stock options or in satisfaction of a tax withholding obligation pursuant to stock awards and (vi) change definition of Fair Market Value, which is also used to determine exercise price for stock options, to the last quoted price of the underlying shares on the stock market on the next preceding date, if the stock market was closed on the grant date. Prior to stockholder approval of the Second Amended 2005 Plan, if stock options were granted on a date which the stock market was closed, the exercise price was equal to the average of the highest and lowest quoted selling prices on the stock market on the day before and the day after the grant date.

Effective October 1, 2005, the Company adopted SFAS No. 123(R) Share-Based Payment (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based payment awards made to the Company s employees and VMS directors including stock options and employee stock purchases under the Employee Stock Purchase Plan, deferred stock units and restricted stock based on fair values.

The table below summarizes the effect of recording share-based compensation expense under SFAS 123(R), which is allocated as follows:

	Three Months Ended		Six Months Ended	
(In thousands, except per share amounts)	**March 30, 2007**	**March 31, 2006**	**March 30, 2007**	**March 31, 2006**
Cost of revenues - Product	$ 1,097	$ 1,164	$ 2,243	$ 1,584
Cost of revenues - Service contracts and other	888	778	1,754	1,394
Research and development	1,212	1,149	2,560	2,093
Selling, general and administrative	8,873	8,629	16,459	14,805
Taxes on earnings	(4,109)	(4,219)	(7,853)	(6,910)
Net decrease in net earnings	$ 7,961	$ 7,501	$ 15,163	$ 12,966
Increase (decrease) on:				
Cash flows from operating activities	$ (4,881)	$ (18,835)	$ (12,513)	$ (43,455)
Cash flows from financing activities	$ 4,881	$ 18,835	$ 12,513	$ 43,455

During the three and six months ended March 30, 2007, total share-based compensation expense recognized in earnings before taxes was $12.1 million and $23.0 million, respectively, and the total related recognized tax benefit was $4.1 million and $7.8 million, respectively. During the three and six months ended March 31, 2006, total share-based compensation expense recognized in earnings before taxes was $11.7 million and $19.9 million, respectively, and the total related recognized tax benefit was $4.2 million and $6.9 million, respectively. Total share-based compensation expense capitalized as part of inventory for the three and six months ended March 30, 2007 was $0.7 million and $1.3 million, respectively. Total share-based compensation expense capitalized as part of inventory for the three and six months ended March 31, 2006 was $0.6 million and $1.1 million, respectively.

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(Unaudited)

The fair value of options granted and the option component of the Employee Stock Purchase Plan shares were estimated at the date of grant using the Black-Scholes model with the following weighted average assumptions:

	Three Months Ended		Six Months Ended	
	March 30, 2007	March 31, 2006	March 30, 2007	March 31, 2006
Employee Stock Option Plans				
Expected term (in years)	4.20	4.25	4.31	4.18
Risk-free interest rate	4.7%	4.5%	4.6%	4.4%
Expected volatility	28.7%	29.2%	29.3%	29.3%
Expected dividend				
Weighted average fair value at grant date	$ 15.40	$ 17.65	$ 16.00	$ 15.50
Employee Stock Purchase Plan				
Expected term (in years)	0.50	0.50	0.50	0.50
Risk-free interest rate	5.1%	4.8%	5.0%	4.5%
Expected volatility	18.7%	27.8%	20.3%	26.5%
Expected dividend				
Weighted average fair value at grant date	$ 10.09	$ 9.33	$ 10.58	$ 9.17

Activity under the Omnibus Stock Plan, the 2000 Stock Option Plan, the 2005 Omnibus Stock Plan, the Amended 2005 Plan and the Second Amended 2005 Plan (together, the Employee Stock Plans) is presented below:

		Options Outstanding			
(In thousands, except per share amounts)	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (3)
Balance at September 29, 2006	3,816	15,111	$ 28.90		
Authorized	2,650				
Granted (1)	(2,767)	2,551	50.62		
Cancelled or expired (2)	101	(98)	42.55		
Exercised		(1,077)	16.98		
Balance at March 30, 2007	3,800	16,487	$ 32.96	6.3	$ 257,245
Exercisable at March 30, 2007		12,077	$ 27.06	5.3	$ 252,835

(1) During the six months ended March 30, 2007, VMS granted to certain employees an aggregate of 54,805 shares of restricted common stock under the Amended 2005 Plan and an aggregate of 2,750 shares of restricted common stock under the Second Amended 2005 Plan. In addition, VMS awarded to its directors an aggregate of 18,000 deferred stock units under the Second Amended 2005 Plan.

(2) During the six months ended March 30, 2007, VMS cancelled 1,255 shares of restricted common stock that were tendered to VMS for employees taxes withheld for vested restricted common stock.

(3) The aggregate intrinsic value represents the total pre-tax intrinsic value, which is computed based on the difference between the exercise price and VMS s closing common stock price of $47.69 as of March 30, 2007 and which would have been received by the option holders had all option holders exercised their options as of that date.

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As of March 30, 2007, there was $53 million of total unrecognized compensation expense related to stock options granted under the Employee Stock Plans. This unrecognized compensation expense is expected to be recognized over a weighted average period of 1.9 years.

The activity for restricted stock, restricted performance shares and deferred stock units is summarized as follows:

(In thousands, except per share amounts)	Shares	Weighted Average Grant-Date Fair Value
Balance at September 29, 2006	66	$ 46.05
Granted	76	50.41
Vested	(4)	56.48
Balance at March 30, 2007	138	$ 48.17

As of March 30, 2007, unrecognized compensation expense totaling $4.7 million was related to restricted stock and deferred stock units granted under the Employee Stock Plans. This unrecognized compensation expense is expected to be recognized over a weighted average period of 6.0 years.

12. EARNINGS PER SHARE

Basic net earnings per share is computed by dividing net earnings by the weighted average number of shares of common stock outstanding for the period. Diluted net earnings per share is computed by dividing net earnings by the sum of the weighted average number of common shares outstanding and dilutive common shares under the treasury method.

The following table sets forth the computation of net basic and diluted earnings per share:

	Three Months Ended		Six Months Ended	
(In thousands, except per share amounts)	March 30, 2007	March 31, 2006	March 30, 2007	March 31, 2006
Net earnings	$ 60,951	$ 55,798	$ 110,452	$ 96,958
Basic weighted average shares outstanding	128,205	131,926	128,689	131,492
Dilutive effect of potential common shares	3,663	4,895	3,820	4,876
Diluted weighted average shares outstanding	131,868	136,821	132,509	136,368
Net earnings per share Basic	$ 0.48	$ 0.42	$ 0.86	$ 0.74
Net earnings per share Diluted	$ 0.46	$ 0.41	$ 0.83	$ 0.71

Pursuant to SFAS 123(R), the Company excludes stock options from the computation of diluted weighted average shares outstanding if the per share value, including the sum of (a) the exercise price of the options, (b) the amount of the compensation cost attributed to future services and not yet recognized and (c) the amount of tax benefit that would be recorded in additional paid-in capital when the award becomes deductible, is

greater than the average market price of the shares, because the inclusion of these stock options would be antidilutive to earnings per share. Accordingly, stock options to purchase 4,421,343 shares and 2,608,219 shares at average exercise prices of $50.62 and $50.35 per share, respectively, were excluded from the computation of diluted weighted average shares outstanding for the three months ended March 30, 2007 and March 31, 2006, respectively. Stock options to purchase 4,349,053 shares and 2,650,855 shares at average exercise prices of $50.46 and $50.19 per share, respectively, were excluded from the computation of diluted weighted average shares outstanding for the six months ended March 30, 2007 and March 31, 2006, respectively.

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13. BUSINESS COMBINATION

In January 2007, the Company acquired all of the outstanding equity of ACCEL, a privately-held supplier of scientific research instruments and proton therapy systems for cancer treatment in Germany, for approximately $20.5 million, plus debt assumed of $10.2 million. The acquisition of ACCEL leverages the Company s existing technology in treatment planning, image guidance and cancer informatics and it enables Varian to offer all the products needed for delivering proton therapy.

The Company s methodology for allocating the purchase price of this purchase acquisition to intangible assets is determined using commonly accepted valuation techniques in the high-technology industry. The valuation method used by the Company included the income approach which established the fair value of the assets based on the value of the cash flows that the assets can be expected to generate in the future using the discounted cash flow method. The purchase price of the transaction was allocated to the acquired assets and liabilities based on their estimated fair values as of the date of acquisition, including identifiable intangible assets, with the remaining amount being classified as goodwill. In connection with this acquisition, $28.5 million was allocated to goodwill, $4.9 million was allocated to identifiable intangible assets and ($12.9) million, net, was allocated to assets and liabilities, including $10.2 million of debt assumed. These amounts reflect a preliminary allocation of the purchase price and are subject to adjustment.

The condensed consolidated financial statements include the operating results of ACCEL from January 1, 2007, as specified in the purchase agreement. Pro forma results of operations have not been presented because the acquisition was not significant.

14. SEGMENT INFORMATION

The Company s operations are grouped into two reportable operating segments: Oncology Systems and X-ray Products. These reportable operating segments were determined based on how the Company s Chief Executive Officer, its Chief Operating Decision Maker (CODM), views and evaluates the Company s operations. The Company s Ginzton Technology Center (GTC), SIP business and the newly acquired ACCEL business are reflected in the Other category because these operations do not meet the criteria of a reportable operating segment as defined under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131). The CODM allocates resources to and evaluates the financial performance of each operating segment primarily based on operating earnings.

The following table summarizes selected operating results information for each business segment:

	Three Months Ended		Six Months Ended	
(In millions)	**March 30, 2007**	**March 31, 2006**	**March 30, 2007**	**March 31, 2006**
Revenues				
Oncology Systems	$ 358	$ 346	$ 675	$ 623
X-ray Products	66	61	128	113
Total reportable segments	$ 424	$ 407	$ 803	$ 736
Other	19	7	28	12
Corporate				
Total company	$ 443	$ 414	$ 831	$ 748
Operating Earnings				
Oncology Systems	$ 90	$ 85	$ 159	$ 147

X-ray Products	16	12	31	21
Total reportable segments	$ 106	$ 97	$ 190	$ 168
Other	(4)	(2)	(5)	(3)
Corporate	(16)	(15)	(29)	(26)
Total company	$ 86	$ 80	$ 156	$ 139

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15. SUBSEQUENT EVENT

On April 25, 2007, the Company announced that it has entered into an agreement to acquire Bio-Imaging Research, Inc., a privately-held supplier of X-ray imaging products for security and inspection, for approximately $21 million.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and

Stockholders of Varian Medical Systems, Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Varian Medical Systems, Inc. and its subsidiaries (the Company) as of March 30, 2007, and the related condensed consolidated statements of earnings for the three-month and six-month periods ended March 30, 2007 and March 31, 2006 and the condensed consolidated statement of cash flows for the six-month periods ended March 30, 2007 and March 31, 2006. These interim financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of September 29, 2006, the related consolidated statements of earnings, stockholders equity and cash flows for the year then ended, management s assessment of the effectiveness of the Company s internal control over financial reporting as of September 29, 2006 and the effectiveness of the Company s internal control over financial reporting as of September 29, 2006; and in our report dated December 11, 2006 on financial statements and internal control over financial reporting, we expressed unqualified opinions thereon. The consolidated financial statements and management s assessment of the effectiveness of internal control over financial reporting referred to above are not presented herein. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of September 29, 2006, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

San Jose, California

April 27, 2007

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 which provides a safe harbor for statements about future events, products and future financial performance that are based on the beliefs of, estimates made by and information currently available to the management of Varian Medical Systems, Inc. (VMS) and its subsidiaries (we, our, or the Company). The outcome of the events described in these forward-looking statements is subject to risks and uncertainties. Actual results and the outcome or timing of certain events may differ significantly from those projected in these forward-looking statements or management s current expectations due to the factors cited in this Management s Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, the Risk Factors listed under Part II, Item 1A of this Quarterly Report on Form 10-Q, and other factors described from time to time in our other filings with the Securities and Exchange Commission, or SEC, or other reasons, which are by this reference incorporated in this Quarterly Report on Form 10-Q. For this purpose, statements concerning industry or market segment outlook; market acceptance of or transition to new products or technology such as intensity-modulated radiation therapy, or IMRT, image-guided radiation therapy, or IGRT, brachytherapy, software, treatment techniques, stereotactic radiosurgery, filmless X-rays and security and inspection products; growth drivers; orders, revenues, backlog or earnings growth; future financial results and any statements using the terms believe, expect, expectation, anticipate, can, should, will, would, could, estimate, appear, based on, may, intended, potential , are emerging and possible or si forward-looking statements. By making forward-looking statements, we have not assumed any obligation to, and you should not expect us to, update or revise those statements because of new information, future events or otherwise.

Overview

Despite modest growth in Oncology Systems net orders and revenues, strong net orders and revenue growth in X-ray Products and the Security and Inspection Products business, or SIP, as well as contribution from the newly acquired ACCEL Instruments GmbH, or ACCEL, contributed to the net order and revenue growth for the second quarter of fiscal year 2007 over the year-ago quarter. Including $47 million in acquired backlog from ACCEL, net orders for the second quarter of fiscal year 2007 were up 23% over the year-ago quarter. Excluding acquired backlog, net orders in the second quarter of fiscal year 2007 grew 12% from the second quarter of fiscal year 2006. Revenues for the second quarter of fiscal year 2007 were up 7% from the year-ago quarter and backlog at March 30, 2007 was up 19% from the end of the second quarter of fiscal year 2006. For the second quarter of fiscal year 2007, we recorded net earnings of $61 million and net earnings per diluted share of $0.46, compared to net earnings of $56 million and net earnings per diluted share of $0.41 in the year-ago quarter. In the second quarter of fiscal year 2007, gross margin was 42%, up by 0.5 percentage points with an increase over the year-ago period of approximately seven percentage points in X-ray Product gross margin as well as a small improvement in Oncology Systems gross margin.

Oncology Systems. Our largest business segment is Oncology Systems, which designs, manufacturers, sells and services hardware and software products for treating cancer with radiation, including linear accelerators, treatment simulation and verification products, brachytherapy equipment, information management and treatment planning software and other sophisticated accessory products and services.

In our view, the fundamental market drivers for long-term growth in radiation therapy and stereotactic radiosurgery continue to be the rising cancer incidence; technology advances that are leading to improvements in patient care; customer demand for more advanced and effective cancer treatments, such as IMRT, IGRT, stereotactic radiosurgery and brachytherapy; competitive conditions among hospitals and clinics to offer such advanced treatments; improvement in cost efficiency in delivering radiation therapy; and underserved medical needs outside of the United States. Our primary goal in the Oncology Systems business segment is to promote the adoption of these more advanced and effective cancer treatments.

Customers are recognizing IGRT and stereotactic radiosurgery as the next significant enhancements in curative radiation therapy. We believe that IGRT will continue to emerge as one of the main contributors to net orders and revenue growth in our Oncology Systems business segment, with North America ahead of international regions in the timing of IGRT adoption. As of March 30, 2007, more than 450 installations of our On-Board Imager product, or OBI, for our high-energy Clinac® accelerators and Trilogy linear accelerators, two of our products for enabling IGRT, were either complete or in progress. As of March 30, 2007, more than 100 Trilogy linear accelerators, which are configured to permit high accuracy, high speed image-guided stereotactic radiosurgery and stereotactic radiotherapy, were installed.

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Reversing our first quarter experience, Oncology Systems net orders in the second quarter of fiscal year 2007 had an unpredicted decline in North America from the year-ago quarter while second quarter international net orders grew solidly from the year-ago period, resulting in overall net orders in Oncology Systems that were flat in the second quarter and the first half of fiscal year 2007 with the year-ago periods. Oncology Systems revenues for the second quarter of fiscal year 2007 also remain relatively flat compared to the year-ago quarter, with a decline in the international regions and growth in North America. We believe we are experiencing greater variability in the length of the customers purchase cycle caused by larger dollar-value transactions for more sophisticated IGRT and surgical equipment, as well as more complex customer decision processes. Also, we are experiencing more customer-requested delays in delivery attributable to the longer preparation and renovation of treatment rooms required for the more sophisticated IGRT-equipped products. Additionally, net orders and revenues for our non-IGRT-related products has declined in the second quarter of fiscal year 2007 compared to the year-ago period. These factors impacted both net orders and revenues for the second quarter of fiscal year 2007 and we see these as issues that will affect us for the rest of the fiscal year, as more of our customers look at adopting IGRT and our backlog contains a high and growing percentage of IGRT-equipped products. We continue to believe that demand for our products that enable IGRT will remain strong in North America as this region continues to adopt new medical technology for IGRT and stereotactic radiosurgery. Additionally, as previously noted, our international regions have experienced a slowdown in demand for radiotherapy capital equipment for IMRT after several years of strong international growth driven by the rapid adoption of IMRT technology. We believe regional fluctuations in demand are consistent with the historical pattern where the international regions and North America region have different cycles of demand and technology adoption. We are, however, seeing a faster adoption rate among the technology early adopters for IGRT as compared to IMRT which may lead to more compressed growth phase cycles.

Our success in Oncology Systems largely depends upon our ability to retain leadership in technological innovation, the cost effectiveness of our products, the efficacy of our treatment technology and external economic influences. Factors affecting the adoption rate of new technologies such as IGRT could include the more-widely demonstrated efficacy of IGRT by early adopters and our internal efficiency in design, documentation and testing, deployment and installation. They may also include customer training, reimbursement and our ability to educate customers about the cost effectiveness of our new technologies and clinical outcome advantages. External economic influences could include hospital financial strength in the United States, foreign currency exchange rates, governmental healthcare policies and government budgeting and tendering cycles.

X-Ray Products. Our X-ray Products business segment manufactures and sells (i) X-ray tubes for use in a range of applications including computed tomography, or CT, scanning, radioscopic/fluoroscopic imaging, mammography, special procedures and industrial applications and (ii) flat panel digital image detectors for X-rays (commonly referred to as flat panel detectors or digital image detectors), which is an alternative to image intensifier tubes for fluoroscopy and X-ray film for radiography. We continue to view the fundamental growth driver for the component business to be the on-going success of key original equipment manufacturers, or OEMs, that incorporate our X-ray tube products and flat panel detectors into their medical diagnostic and industrial imaging systems. Our flat panel detectors are being incorporated into new filmless X-ray imaging equipment for medical diagnostics, dental imaging, veterinary care and industrial inspection.

In the second quarter of fiscal year 2007, the flat panel detector product line continued to be the primary contributor to X-ray Products solid net orders, revenues and gross margin growth over the same period of fiscal year 2006. We have completed the expansion of our Salt Lake City, Utah, manufacturing facility where our flat panel detector product line is manufactured to give us additional capacity.

We have invested $23 million as of March 30, 2007 and expect to invest an additional $14 million over the next five months into dpiX Holding LLC, or dpiX Holding, which will help fund the acquisition and construction of a new $92 million Gen 4 fabrication facility in Colorado where the next generation of amorphous silicon arrays will be produced. dpiX Holding (through its subsidiary, dpiX LLC) is a key supplier of amorphous silicon arrays for our flat panel detector products and we are a 40% equity owner in dpiX Holding.

Our success in our X-ray Products business depends upon our ability to anticipate changes in our markets, the direction of technological innovation and the demands of our customers. Factors affecting the success of our X-ray Products business include our ability to develop products with lower cost, better quality and superior technology and performance, and to maintain strong relationships with our OEM customers.

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Other. The Other category is comprised of SIP, the newly acquired ACCEL proton therapy and scientific research instruments business and the operations of the Ginzton Technology Center, or GTC (see Note 14 Segment Information of the Notes to the Condensed Consolidated Financial Statements within this Quarterly Report on Form 10-Q).

SIP designs, manufactures, sells and services Linatron® X-ray accelerators for security and inspection purposes, such as cargo screening, border protection and nondestructive examination for a variety of applications. We generally sell our Linatron X-ray accelerators to OEMs who incorporate our accelerators into their inspection systems, which are then sold to customs agencies and other government and military agencies, as well as to commercial private parties in the casting, power, aerospace, chemical, petro-chemical and automotive industries. On April 25, 2007, we announced that we entered into an agreement to acquire Bio-Imaging Research, Inc., or BIR, a privately-held supplier of X-ray imaging products for security and inspection, for approximately $21 million. This acquisition will enable us to offer security and inspection customers X-ray imaging detectors and image processing software in addition to our existing line of specialized linear accelerators for cargo screening, inspection and non-destructive testing. BIR will operate under our SIP business unit.

We believe growth in this business will be driven by security cargo screening and border protection needs, as well as by the needs of customs agencies to verify shipments for assessing duties and taxes. As a result, this business is heavily influenced by U.S. and foreign governmental policies on national and homeland security, border protection and customs revenue activities, which depend upon government budgets and appropriations and which are subject to political changes. While we are optimistic about the long-term potential of our SIP business and encouraged by the increased interest in our SIP products, use of this technology in security cargo screening and border protection is in its early stages. Orders and revenues for our SIP products may be unpredictable as governmental agencies may place larger orders with our OEM customers in a short time period and then may not place any orders for a long time period thereafter.

In January 2007, we completed the acquisition of ACCEL, a privately-held supplier of scientific research instruments and proton therapy systems for cancer treatment. The acquisition will enable us to offer products for delivering image-guided, intensity-modulated proton therapy for certain cancer patients. Proton therapy directs protons into the tumor and disrupts the cancer cells ability to reproduce. The ability to accurately target and kill tumor cells with less dose to nearby healthy tissue makes proton therapy a preferred option for treating certain kinds of cancers. Due to its relatively large scale, the construction of a proton therapy facility requires significant capital investment and may involve complex project financing. Therefore, sales and customer decision cycles may take several years. We believe that growth in this business will initially develop in the major metropolitan areas in the United States and abroad, and that this market is driven by institutions that wish to expand their clinical offering and increase their profile in their respective communities. We see a high level of interest in the marketplace world-wide for this type of technology and believe that Varian can leverage its sophisticated technology in radiation therapy into the proton therapy market, improving clinical utility for existing clinical applications and possibly expanding the use of proton therapy into a broader array of cancer types. There are several competitors in this market, some of whom may have access to government support and/or may not be as focused on maintaining profitability and are willing to forsake profitability for market share. Orders and revenues for proton therapy products may be unpredictable due to these factors.

The Scientific Instruments division of ACCEL develops, manufactures and services customized components and turnkey systems primarily for national research laboratories for fundamental and applied physics. This scientific instruments market is driven by a few large projects in the billion-dollar range and an increasing number of national accelerator projects ranging from one to five hundred million dollars. As the research projects in this market are all publicly funded, decisions on new projects or project upgrades are subject to public and political factors. In the scientific instruments market, ACCEL competes with other companies as well as the internal engineering and fabrication capabilities in the national research laboratories. While it appears that there is relatively steady growth in the number and volume of these research projects worldwide, the timing of these research projects may vary significantly. Therefore, ACCEL engineering and manufacturing resources will fluctuate over time as they adapt to the resource requirements of these research projects. Due to the above factors, orders, revenues and profitability of the ACCEL Scientific Instruments business may not be easily predictable.

GTC, our research facility for new and potential markets, continues to invest in developing technologies that enhance our current businesses or may lead to new business areas, including next generation digital X-ray imaging technology, volumetric and functional imaging, improved X-ray sources and technology for security and cargo screening applications. In addition, GTC is developing technologies and products that are designed to improve disease management by more precise targeting of radiation, as well as by employing targeted energy and molecular agents to enhance the effectiveness and broaden the application of radiation therapy.

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The Other business category contributed significantly to revenues and net order growth in the second quarter of fiscal year 2007 over the same quarter in the fiscal year 2006. The Other category reported combined revenues of $19 million, which included a contribution of $9 million from ACCEL and was up $12 million from the year-ago quarter. Excluding $47 million of acquired backlog, the ACCEL business contributed $22 million in the second quarter of fiscal year 2007 in new net orders for proton therapy services and scientific instruments products. In our SIP business, orders for cargo screening systems in international markets and replacements of older products for industrial inspection and non-destructive testing grew significantly in the second quarter of fiscal year 2007 over the year-ago period.

This discussion and analysis of our financial condition and results of operations is based upon and should be read in conjunction with the Condensed Consolidated Financial Statements and the notes included elsewhere in this report, as well as the Consolidated Financial Statements and the Notes to the Consolidated Financial Statements and the related Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended September 29, 2006, as well as the Risk Factors contained in Part II, Item 1A of this Quarterly Report on Form 10-Q, and other information provided from time to time in our other filings with the SEC.

Critical Accounting Estimates

The preparation of our financial statements and related disclosures in conformity with generally accepted accounting principles in the United States of America, or GAAP, requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. These estimates and assumptions are based on historical experience and on various other factors that we believe are reasonable under the circumstances. We periodically review our accounting policies and estimates and make adjustments when facts and circumstances dictate. Our critical accounting policies that are affected by accounting estimates include share-based compensation expense, revenue recognition, valuation of allowance for doubtful accounts, valuation of inventories, assessment of recoverability of goodwill and intangible assets, valuation of warranty obligations, assessment of environmental remediation liabilities, valuation of defined benefit and post-retirement benefit plans and valuation of taxes on earnings. Such accounting policies are impacted significantly by judgments, assumptions and estimates used in the preparation of our Condensed Consolidated Financial Statements, and actual results could differ materially from these estimates. For a discussion of how these estimates and other factors may affect our business, also see the Risk Factors listed under Part II, Item 1A of this Quarterly Report on Form 10-Q.

Share-based Compensation Expense

Effective October 1, 2005, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment,* or SFAS 123(R), using the modified prospective transition method. We have valued our share-based payment awards granted beginning in fiscal year 2006 using the Black-Scholes option-pricing model. The determination of fair value of share-based payment awards on the date of grant using the Black-Scholes option-pricing model is affected by VMS s stock price as well as the input of other subjective assumptions, including the expected term of stock awards and the expected price volatility of VMS stock over the expected term of the awards.

The expected term is based on the observed and expected time to post-vesting exercise and post-vesting cancellations of stock options by our employees. Upon the adoption of SFAS 123(R), we determined the expected term of stock options based on the demographic grouping of employees and retirement eligibility. Upon adoption of SFAS 123(R), we used a combination of historical and implied volatility, or blended volatility, in deriving the expected volatility assumption. The blended volatility represents the weighted average of implied volatility and historical volatility. Implied volatility was derived based on six-month traded options on VMS common stock. Implied volatility is weighted in the calculation of blended volatility based on the ratio of the six-month term of the exchange-traded options to the expected lives of the employee stock options. Historical volatility represents the remainder of the weighting. Our decision to incorporate implied volatility was based on our assessment that implied volatility of publicly traded options in our common stock is reflective of market conditions and is generally reflective of both historical volatility and expectations of how future volatility will differ from historical volatility. In determining the extent of use of implied volatility, we considered: (i) the volume of market activity of traded options; (ii) the ability to reasonably match the input variables of traded options to those of stock options granted by us, including the date of grant; (iii) the similarity of the exercise prices; and (iv) the length of term of traded options. After considering the above factors, we determined that we cannot rely exclusively on implied volatility based on that fact that the term our six-month exchange-traded options is less than one year and that it is different from the expected lives of the stock options granted by us. Therefore, we believe a combination of the historical volatility over the expected lives of the stock options granted by us and the implied volatility of six-month exchange-traded options best reflects the expected volatility of our stock going forward. The risk-free interest rate assumption is based upon observed interest rates

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appropriate for the term of our stock options. The dividend yield assumption is based on our history and expectation of dividend payouts. If factors change and we employ different assumptions in the application of SFAS 123(R) in future periods, the compensation expense that we record under SFAS 123(R) may differ significantly from what we have recorded in the current period. In addition, we are required to estimate the expected forfeiture rate and recognize expense only for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period.

Revenue Recognition

We frequently enter into sales arrangements with customers that contain multiple elements or deliverables such as hardware, software and services. Judgments as to the allocation of the proceeds received from an arrangement to the multiple elements of the arrangement, the determination of whether any undelivered elements are essential to the functionality of the delivered elements and the appropriate timing of revenue recognition are critical in respect to these arrangements to ensure compliance with GAAP. In addition, the amount of product revenues recognized is affected by our judgments as to whether objective and reliable evidence of fair value exists for hardware products and vendor-specific objective evidence of the fair value for software products in arrangements with multiple elements. Changes to the elements in an arrangement and the ability to establish objective and reliable evidence of fair value or vendor-specific objective evidence of the fair value for those elements could affect the timing of revenue recognition. Revenue recognition also depends on the timing of shipment and is subject to customer acceptance and the readiness of customers facilities. If shipments are not made on scheduled timelines or if the products are not accepted by the customer in a timely manner, our reported revenues may differ materially from expectations. In addition, revenues recognized related to contracts for certain proton therapy and scientific instruments products and services under the percentage of completion method involves considerable use of estimates in determining revenues, costs and profits and in assigning the amounts to accounting periods and, as a result, our recorded revenues may be adjusted in later periods in the event that our cost estimates prove to be inaccurate or a contract is terminated.

Allowance for Doubtful Accounts

Credit evaluations are undertaken for all major sale transactions before shipment is authorized. Normal payment terms usually require payment of a small portion of the total amount due upon signing of the purchase order contract, a significant amount upon transfer of risk of loss and the remaining amount upon completion of the installation. On a quarterly basis, we evaluate aged items in the accounts receivable aging report and provide an allowance in an amount we deem adequate for doubtful accounts. If our evaluation of our customers financial conditions does not reflect the future ability to collect outstanding receivables, additional provisions may be needed and our future operating results could be negatively impacted.

Inventories

Our inventories include high technology parts and components that are specialized in nature or subject to rapid technological obsolescence. We have programs to minimize the required inventories on hand and we regularly review inventory quantities on hand and adjust for excess and obsolete inventory based primarily on historical usage rates and our estimates of product demand and production. Actual demand may differ from our estimates, in which case we may have understated or overstated the provision required for obsolete and excess inventory, which would have an impact on our operating results.

Goodwill and Intangible Assets

Goodwill is initially recorded when the purchase price paid for a business acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. The majority of companies that we have acquired have not had significant identified tangible assets and, as a result, a significant portion of the purchase price has been typically allocated to intangible assets and goodwill. Our future operating performance will be impacted by the future amortization of these acquired intangible assets and potential impairment charges related to goodwill if indicators of impairment exist. As a result of business acquisitions, the allocation of the purchase price to goodwill and intangible assets could have a significant impact on our future operating results. The allocation of the purchase price of the acquired companies to goodwill and intangible assets requires us to make significant estimates and assumptions, including estimates of future cash flows expected to be generated by the acquired assets and the appropriate discount rate for these cash flows. Should conditions be different from management s estimates at the time of the acquisition, material write-downs of intangible assets and/or goodwill may be required, which would adversely affect our operating results.

We evaluate goodwill and purchased assets with indefinite lives for impairment annually in accordance with SFAS 142 Goodwill and Other Intangible Assets. The impairment test for goodwill is a two-step process. Step one consists of a

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comparison of the fair value of a reporting unit with its carrying amount, including the goodwill allocated to each reporting unit. We determine the fair value of its reporting units based on the present value of estimated future cash flows of the reporting units. The reporting units are consistent with the reportable operating segments identified in Note 14 Segment Information . If the carrying amount is in excess of the fair value, step two requires the comparison of the implied fair value of the reporting unit with the carrying amount of the reporting unit s goodwill. Any excess of the carrying value of the reporting unit s goodwill over the implied fair value of the reporting unit s goodwill is recorded as an impairment loss. The impairment test for intangible assets with indefinite useful lives, if any, consists of a comparison of fair value to carrying value, with any excess of carrying value over fair value being recorded as an impairment loss. We will continue to make assessments of impairment on an annual basis in the fourth quarter of our fiscal years or more frequently if indicators of potential impairment arise. We performed such evaluations for the two reporting units that carried goodwill in the fourth quarter of fiscal year 2006, Oncology Systems and X-ray Products, and found no impairment.

Warranty Obligations

We warrant most of our products for a specific period of time, usually one year, against material defects. We provide for the estimated future costs of warranty obligations in cost of revenues when the related revenues are recognized. The accrued warranty costs represent our best estimate at the time of sale of the total costs that we will incur to repair or replace product parts that fail while still under warranty. The amount of accrued estimated warranty costs obligation for established products is primarily based on historical experience as to product failures adjusted for current information on repair costs. For new products, estimates will include historical experience of similar products, as well as reasonable allowance for start-up expenses. Actual warranty costs could differ from the estimated amounts. On a quarterly basis, we review the accrued balances of our warranty obligations and update the historical warranty cost trends. If we were required to accrue additional warranty cost in the future, it would negatively impact our operating results.

Environmental Matters

We are subject to a variety of environmental laws around the world regulating the handling, storage, transport and disposal of hazardous materials that do or may create increased costs for some of our operations. Environmental remediation liabilities are recorded when environmental assessments and/or remediation efforts are probable and the costs of these assessments or remediation efforts can be reasonably estimated, in accordance with Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies,* and the American Institute of Certified Public Accountants, Statement of Position 96-1, *Environmental Remediation Liabilities.* The accrued environmental costs represent our best estimate as to the total costs of remediation and the time period over which these costs will be incurred. On a quarterly basis, we review these accrued balances.