VARIAN MEDICAL SYSTEMS INC
Form 10-Q
August 07, 2012
Table of Contents

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 June 29, 2012

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	**(I.R.S. Employer**
incorporation or organization)	**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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 110,715,329 shares of common stock, par value $1 per share, outstanding as of July 27, 2012.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC.

FORM 10-Q for the Quarter Ended June 29, 2012

INDEX

Table of Contents

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

(In thousands, except per share amounts)	Three Months Ended June 29, 2012	Three Months Ended July 1, 2011	Nine Months Ended June 29, 2012	Nine Months Ended July 1, 2011
Revenues:				
Product	$ 526,331	$ 490,419	$ 1,529,935	$ 1,420,956
Service contracts and other	178,915	159,019	520,923	456,789
Total revenues	705,246	649,438	2,050,858	1,877,745
Cost of revenues:				
Product	311,358	291,080	923,981	817,473
Service contracts and other	86,277	78,603	253,811	224,684
Total cost of revenues	397,635	369,683	1,177,792	1,042,157
Gross margin	307,611	279,755	873,066	835,588
Operating expenses:				
Research and development	48,943	44,426	139,775	126,801
Selling, general and administrative	105,081	94,838	306,986	280,072
Total operating expenses	154,024	139,264	446,761	406,873
Operating earnings	153,587	140,491	426,305	428,715
Interest income	1,312	584	3,571	2,022
Interest expense	(933)	(504)	(2,469)	(1,868)
Earnings from operations before taxes	153,966	140,571	427,407	428,869
Taxes on earnings	45,123	41,966	120,559	130,696
Net earnings	$ 108,843	$ 98,605	$ 306,848	$ 298,173
Net earnings per share basic	$ 0.98	$ 0.84	$ 2.74	$ 2.54
Net earnings per share diluted	$ 0.96	$ 0.83	$ 2.69	$ 2.49
Shares used in the calculation of net earnings per share:				
Weighted average shares outstanding basic	111,070	116,874	111,857	117,614

Weighted average shares outstanding diluted	112,823	119,064	113,961	119,831

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except par values)	June 29, 2012	September 30, 2011 [1]
Assets		
Current assets:		
Cash and cash equivalents	$ 633,386	$ 564,457
Short-term investment	47,155	19,205
Accounts receivable, net of allowance for doubtful accounts of $10,647 at June 29, 2012 and $6,034 at September 30, 2011	608,834	635,153
Inventories	464,436	409,962
Prepaid expenses and other current assets	150,430	111,875
Deferred tax assets	113,246	113,965
Total current assets	2,017,487	1,854,617
Property, plant and equipment, net	287,336	285,894
Goodwill	224,058	212,452
Other assets	189,072	145,798
Total assets	$ 2,717,953	$ 2,498,761
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 147,248	$ 154,946
Accrued expenses	284,705	290,009
Product warranty	49,323	50,128
Deferred revenues	126,348	140,173
Advance payments from customers	353,943	299,380
Short-term borrowings	168,760	181,400
Current maturities of long-term debt	0	9,876
Total current liabilities	1,130,327	1,125,912
Long-term debt	6,250	6,250
Other long-term liabilities	118,051	122,708
Total liabilities	1,254,628	1,254,870
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock of $1 par value: 1,000 shares authorized; none issued and outstanding	0	0
Common stock of $1 par value: 189,000 shares authorized; 110,711 and 112,344 shares issued and outstanding at June 29, 2012 and at September 30, 2011, respectively	110,711	112,344
Capital in excess of par value	568,943	500,922
Retained earnings	834,851	677,473
Accumulated other comprehensive loss	(51,180)	(46,848)

Total stockholders equity	1,463,325	1,243,891
Total liabilities and stockholders equity	$ 2,717,953	$ 2,498,761

(1) The condensed consolidated balance sheet as of September 30, 2011 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.

4

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended	
(In thousands)	June 29, 2012	July 1, 2011
Cash flows from operating activities:		
Net earnings	$ 306,848	$ 298,173
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Share-based compensation expense	36,655	34,912
Tax benefits from exercises of share-based payment awards	6,647	23,597
Excess tax benefits from share-based compensation	(7,805)	(21,768)
Depreciation	39,711	36,708
Amortization of intangible assets	2,848	2,280
Deferred taxes	(275)	9,585
Provision for doubtful accounts receivable	6,240	2,065
Income on equity investment in affiliate	(1,225)	(4,488)
Other	(858)	34
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable	(4,170)	24,961
Inventories	(49,271)	(68,310)
Prepaid expenses and other current assets	(47,665)	(24,627)
Accounts payable	(7,668)	(2,497)
Accrued expenses	(10,574)	(104)
Deferred revenues	(16,992)	(10,904)
Product warranty	4	(3,615)
Advance payments from customers	54,823	40,935
Other long-term liabilities	(5,911)	(10,010)
Net cash provided by operating activities	301,362	326,927
Cash flows from investing activities:		
Purchases of property, plant and equipment	(40,188)	(52,289)
Investment in a privately held company	0	(13,597)
Investment in debt security	(27,950)	0
Acquisition of businesses, net of cash acquired	(28,241)	(8,399)
(Increase) decrease in cash surrender value of life insurance	(2,708)	425
Note repayment from affiliate and other, net	3,360	(7,492)
Other, net	(2,340)	(3,495)
Net cash used in investing activities	(98,067)	(84,847)
Cash flows from financing activities:		
Repurchases of common stock	(172,418)	(238,000)
Equity forward contracts	0	(68,063)
Proceeds from issuance of common stock to employees	54,529	132,524
Excess tax benefits from share-based compensation	7,805	21,768
Employees taxes withheld and paid for restricted stock and restricted stock units	(8,598)	(14,188)
Net repayments under line of credit agreements	(12,585)	(20,000)
Repayments of bank borrowings	(9,876)	(5,459)

Other	(74)	(52)
Net cash used in financing activities	(141,217)	(191,470)
Effects of exchange rate changes on cash and cash equivalents	6,851	(2,909)
Net increase in cash and cash equivalents	68,929	47,701
Cash and cash equivalents at beginning of period	564,457	520,221
Cash and cash equivalents at end of period	$ 633,386	$ 567,922

Supplemental information:

VMS common stock valued at $25.0 million was received in the nine months ended June 29, 2012 upon settlement of the August 2011 Repurchase Agreement. See Note 12, Stockholders Equity. VMS common stock valued at $41.3 million was received during the nine months ended July 1, 2011 upon settlement of the February 2011 Repurchase Agreement. See Note 12, Stockholders Equity to the Consolidated Financial Statements of the Company s 2011 Annual Report for further discussion of the February 2011 Repurchase Agreement.

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

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 equipment and software products for treating cancer with radiotherapy, stereotactic radiosurgery, stereotactic body radiotherapy and brachytherapy. The Company also designs, manufactures, sells and services X-ray tubes for original equipment manufacturers (OEMs); replacement X-ray tubes; and flat panel digital image detectors for filmless x-rays imaging in medical, dental, veterinary, scientific and industrial applications. It designs, manufactures, sells and services linear accelerators, digital image detectors, image processing software and image detection products for security and inspection purposes. The Company also develops, designs, manufacturers, sells and services proton therapy products and systems for cancer treatment.

Basis of Presentation

The condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements and the accompanying notes are unaudited and should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended September 30, 2011 (the 2011 Annual Report). In the opinion of management, the condensed consolidated financial statements herein include adjustments (consisting only of normal recurring adjustments) necessary for a fair statement of the Company s financial position as of June 29, 2012 and September 30, 2011, results of operations for the three and nine months ended June 29, 2012 and July 1, 2011, and cash flows for the nine months ended June 29, 2012 and July 1, 2011. The results of operations for the three and nine months ended June 29, 2012 are not necessarily indicative of the operating results to be expected for the full fiscal year or any future period.

Fiscal Year

The fiscal years of the Company as reported are the 52- or 53- week periods ending on the Friday nearest September 30. Fiscal year 2012 is the 52-week period ending September 28, 2012, and fiscal year 2011 was the 52-week period that ended on September 30, 2011. The fiscal quarters ended June 29, 2012 and July 1, 2011 were both 13-week periods.

Principles of Consolidation

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

Use of Estimates

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

Investments in Privately Held Companies

Equity investments in privately held companies in which the Company holds at least a 20% ownership interest or in which the Company has the ability to exercise significant influence are accounted for by the equity method. Equity investments in privately held companies in which the Company holds less than a 20% ownership interest and does not have the ability to exercise significant influence are accounted for under the cost method. Equity investments accounted for under the cost method totaled $21.4 million at both June 29, 2012 and September 30, 2011. The Company s equity investments in privately held companies are included in Other assets in the Consolidated Balance Sheets. The Company monitors these equity investments for impairment and makes appropriate reductions in carrying values if the Company determines that impairment

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

charges are required based primarily on the financial condition and near-term prospects of these companies. The Company did not have any impairment loss on equity investments in privately held companies during both the three and nine months ended June 29, 2012 and July 1, 2011.

Reclassifications

Certain items in the condensed consolidated statements of cash flows have been reclassified to conform to the current fiscal year s format. These reclassifications had no impact on previously reported total net earnings.

Recent Accounting Pronouncements

In December 2011, the Financial Accounting Standards Board (FASB) amended Accounting Standard Codification (ASC) 210, Balance Sheet. This amendment enhances disclosure requirements about the nature of an entity s right to offset and related arrangements associated with its financial instruments and derivative instruments. The new guidance requires the disclosure of the gross amounts subject to rights of set-off, the amounts offset in accordance with the accounting standards followed, and the related net exposure. The new guidance will be effective for the Company beginning in the first quarter of fiscal year 2014. The adoption of this amendment concerns disclosure only and the Company does not expect it to have an impact on its consolidated financial position, results of operations or cash flows.

In September 2011, the FASB amended ASC 350, Intangibles Goodwill and Other. This amendment is intended to simplify how an entity tests goodwill for impairment and will allow an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. An entity no longer will be required to calculate the fair value of a reporting unit unless the entity determines, based on a qualitative assessment, that it is more likely than not that the reporting unit s fair value is less than its carrying amount. The amendment will be effective for the Company beginning in the first quarter of fiscal 2013 and early adoption is permitted. The Company does not expect this amendment to have a material impact on its consolidated financial position, results of operations and cash flows.

In June 2011, the FASB amended ASC 220, Presentation of Comprehensive Income. This amendment will require companies to present the components of net income and other comprehensive income either as one continuous statement or as two consecutive statements. It eliminates the option to present components of other comprehensive income as part of the statement of changes in stockholders equity. In December 2011, the FASB issued another amendment which defers indefinitely this amendment to the extent it relates to the presentation of reclassification adjustments. The amended guidance, which must be applied retroactively, will be effective for the Company in the first quarter of fiscal year 2013. The adoption of this amendment concerns disclosure only and the Company does not expect it to have an impact on its consolidated financial position, results of operations or cash flows.

2. BALANCE SHEET COMPONENTS:

(in millions)	June 29, 2012	September 30, 2011
Short-term Investment:		
Corporate debt security:		
Amortized cost	$ 47.2	$ 19.2
Unrealized gain (loss)	0.0	0.0
Fair value	$ 47.2	$ 19.2

The short-term investment, which represents a loan to California Proton Treatment Center, LLC (CPTC), is classified as an available-for-sale corporate debt security. See Note 15, Variable Interest Entity.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

The components of inventories were as follows:

(In millions)	June 29, 2012	September 30, 2011
Inventories:		
Raw materials and parts	$ 232.6	$ 231.9
Work-in-progress	81.8	54.5
Finished goods	150.0	123.6
Total inventories	$ 464.4	$ 410.0

The components of other long-term liabilities were as follows:

(In millions)	June 29, 2012	September 30, 2011
Other long-term liabilities:		
Long-term income taxes payable	$ 41.1	$ 44.8
Other	77.0	77.9
Total other long-term liabilities	$ 118.1	$ 122.7

3. FAIR VALUE

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

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

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

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

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Assets/Liabilities Measured at Fair Value on a Recurring Basis

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

	Fair Value Measurement Using			
Type of Instruments (In millions)	**Quoted Prices in Active Markets for Identical Instruments (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Total Balance**
Assets at June 29, 2012:				
Money market funds	$ 22.6	$ 0.0	$ 0.0	$ 22.6
Corporate debt security	0.0	0.0	47.2	47.2
Derivative assets	0.0	0.6	0.0	0.6
Option to purchase a company	0.0	0.0	1.4	1.4
Total assets measured at fair value	$ 22.6	$ 0.6	$ 48.6	$ 71.8
Liabilities at June 29, 2012:				
Contingent consideration	$ 0.0	$ 0.0	$ (9.1)	$ (9.1)
Total liabilities measured at fair value	$ 0.0	$ 0.0	$ (9.1)	$ (9.1)
Assets at September 30, 2011:				
Money market funds	$ 1.3	$ 0.0	$ 0.0	$ 1.3
Corporate debt security	0.0	0.0	19.2	19.2
Option to purchase a company	0.0	0.0	1.4	1.4
Total assets measured at fair value	$ 1.3	$ 0.0	$ 20.6	$ 21.9
Liabilities at September 30, 2011:				
Contingent consideration	$ 0.0	$ 0.0	$ (0.1)	$ (0.1)
Total liabilities measured at fair value	$ 0.0	$ 0.0	$ (0.1)	$ (0.1)

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Line Item in Consolidated Balance Sheet (In millions)	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Balance
	Fair Value Measurement Using			
Assets at June 29, 2012:				
Cash and cash equivalents	$ 21.5	$ 0.0	$ 0.0	$ 21.5
Short-term investment	0.0	0.0	47.2	47.2
Prepaid expenses and other current assets	0.0	0.6	0.0	0.6
Other assets	1.1	0.0	1.4	2.5
Total assets measured at fair value	$ 22.6	$ 0.6	$ 48.6	$ 71.8
Liabilities at June 29, 2012:				
Accrued liabilities	$ 0.0	$ 0.0	$ (1.9)	$ (1.9)
Other long-term liabilities	0.0	0.0	(7.2)	(7.2)
Total liabilities measured at fair value	$ 0.0	$ 0.0	$ (9.1)	$ (9.1)
Assets at September 30, 2011:				
Cash and cash equivalents	$ 0.2	$ 0.0	$ 0.0	$ 0.2
Short-term investment	0.0	0.0	19.2	19.2
Other assets	1.1	0.0	1.4	2.5
Total assets measured at fair value	$ 1.3	$ 0.0	$ 20.6	$ 21.9
Liabilities at September 30, 2011:				
Other long-term liabilities	$ 0.0	$ 0.0	$ (0.1)	$ (0.1)
Total liabilities measured at fair value	$ 0.0	$ 0.0	$ (0.1)	$ (0.1)

The Company obtains valuations of Level 1 money market funds from quotes for transactions in active exchange markets involving identical assets.

The Company s valuation of its Level 2 instruments includes valuations obtained from quoted prices for identical assets in markets that are not active. In addition, the Company has elected to use the income approach to value its derivative instruments using standard valuation techniques and Level 2 inputs, such as currency spot rates, forward points and credit default swap spreads. The Company s derivative instruments are short-term in nature, typically one month to twelve months in duration.

The Company measures the fair value of its Level 3 contingent consideration liabilities based on the income approach by using a Monte Carlo simulation model with key assumptions that include estimated sales units of an acquired business during the earn-out period and estimated discount rates corresponding to the periods of expected payments. For the acquisition of Calypso Medical Technologies, Inc. (Calypso) (see

Note 18, Business Combinations), the estimated sales units used in the Monte Carlo simulation model ranged from 69 to 193 units during the earn-out period. The estimated discount rates used ranged from 0.13% to 0.42%. For the acquisition of InfiMed, Inc. (InfiMed) (see Note 18, Business Combinations), the estimated sales units used in the risk-neutral Monte Carlo simulation model ranged from 171 to 299 units per quarter during the earn-out period. Since the analysis of the InfiMed of contingent consideration liability was performed in a risk-neutral option pricing framework, the estimated discount rates used ranged from 1.37% to 1.75%, based on U.S. Treasury rates and an estimate of the Company s counter-party risk. If the estimated sales units were to increase or decrease during the respective earn-out period, the fair value of the contingent consideration would increase or decrease, respectively. If the estimated discount rates used were to increase or decrease, the fair value of the contingent consideration would decrease or increase, respectively.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

The Company s Level 3 corporate debt security is valued based on the income approach by using the discounted cash flow model with key assumptions that include discount rates corresponding to the terms and risks associated with the loan to CPTC. If the estimated discount rates used were to increase or decrease, the fair value of the corporate debt security would decrease or increase, respectively.

The fair value of the option to purchase a company, a Level 3 asset, is based on the income approach using key assumptions that include projected operating results of the company and an estimated discount rate corresponding to the period of expected payment.

The following table presents the reconciliation for all assets and liabilities measured and recorded at fair value on a recurring basis using significant unobservable inputs (Level 3):

(In millions)	Corporate Debt Security	Contingent Consideration	Option to Purchase a Company
Balance at September 30, 2011	$ 19.2	$ (0.1)	$ 1.4
Purchases[1]	6.1	(4.9)	0.0
Balance at December 30, 2011	25.3	(5.0)	1.4
Purchases[1]	6.3	0.0	0.0
Balance at March 30, 2012	31.6	(5.0)	1.4
Purchases[1]	15.6	(4.1)	0.0
Balance at June 29, 2012	$ 47.2	$ (9.1)	$ 1.4

(1) Amounts reported under Contingent Consideration represent additions to contingent consideration liabilities as a result of acquisitions of businesses.

There were no transfers of assets or liabilities between fair value measurement levels during either the three and nine months ended June 29, 2012 or the three and nine months ended July 1, 2011. Transfers between fair value measurement levels are recognized at the end of the reporting period.

Fair Value of Other Financial Instruments

In the table below, the Company has segregated the fair value of certain financial instruments that are not measured at fair value on a recurring basis into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value at the measurement date.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

	Fair Value Measurement Using			
Type of Instruments (In millions)	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Balance
At June 29, 2012:				
Bank deposits (included in Cash and cash equivalents)	$ 611.9	$ 0.0	$ 0.0	$ 611.9
Short-term borrowings	0.0	(168.8)	0.0	(168.8)
Long-term debt	0.0	(6.9)	0.0	(6.9)
At September 30, 2011:				
Bank deposits (included in Cash and cash equivalents)	$ 564.3	$ 0.0	$ 0.0	$ 564.3
Short-term borrowings	0.0	(181.4)	0.0	(181.4)
Long-term debt	0.0	(17.2)	0.0	(17.2)

The fair values of certain of the Company s financial instruments that are not measured at fair value, including bank deposits, short-term borrowings, accounts payable and accounts receivable, net of allowance for doubtful accounts, approximate their carrying amounts due to their short maturities.

The estimated fair value of long-term debt was based on the then-current rates available to the Company for debt of similar terms and remaining maturities and also took into consideration default and credit risk. The Company determined the estimated fair value amount by using available market information and commonly accepted valuation methodologies. However, considerable judgment is required in interpreting market data to develop estimates of fair value. The use of different assumptions and/or estimation methodologies may have a material effect on the estimated fair value.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

4. FINANCING RECEIVABLES AND ALLOWANCE FOR CREDIT LOSSES

A financing receivable is a contractual right to receive money, on demand or on fixed or determinable dates, that is recognized as an asset in the creditor s balance sheet. The Company s financing receivables, consisting of its accounts receivable with contractual maturities of more than one year and the related allowance for doubtful accounts, notes receivable and short-term investment, are presented in the following table:

(In millions)	June 29, 2012	September 30, 2011
Accounts receivable with contractual maturities of more than one year:		
Gross amount	$ 26.8	$ 16.2
Allowance for doubtful accounts	0.0	0.0
Net amount	$ 26.8	$ 16.2
Amount past due	$ 0.9	$ 1.2
Note receivable:		
Note receivable from related party	$ 5.4	$ 8.8
Amount past due	$ 0.0	$ 0.0
Short-term investment:		
Total short-term investment[1]	$ 47.2	$ 19.2
Amount past due	$ 0.0	$ 0.0

1 Represents a loan to CPTC. See Note 15, Variable Interest Entity.

During the three and nine months ended June 29, 2012, the Company sold $2.2 million and $9.7 million, respectively, of accounts receivable with contractual maturities of more than one year. There was no significant activity in the allowance for doubtful financing receivable accounts during the three and nine months ended June 29, 2012.

5. 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 in the Condensed Consolidated Balance Sheets as follows:

(In millions)	June 29, 2012	September 30, 2011
Intangible Assets:		
Acquired existing technology	$ 36.3	$ 26.0

Patents, licenses and other	22.1	19.6
Customer contracts and supplier relationship	10.9	10.4
Accumulated amortization	(46.4)	(43.7)
Net carrying amount	$ 22.9	$ 12.3

Amortization expense for intangible assets was $1.1 million and $0.7 million for the three months ended June 29, 2012 and July 1, 2011, respectively, and $2.8 million and $2.3 million for the nine months ended June 29, 2012 and July 1, 2011, respectively. The Company estimates amortization expense on a straight-line basis for the remaining three months of fiscal year 2012, fiscal year 2013, fiscal year 2014, fiscal year 2015, fiscal year 2016 and thereafter, will be as follows (in millions): $1.1, $4.3, $3.4, $3.0 and $11.1, respectively.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

The following table reflects the activity of goodwill by reportable operating segment:

(In millions)	Oncology Systems	X-ray Products	Other	Total
Balance at September 30, 2011	$ 130.5	$ 6.1	$ 75.9	$ 212.5
Acquisition of businesses	4.1	10.9	0.0	15.0
Foreign currency translation adjustments	0.0	0.0	(3.4)	(3.4)
Balance at June 29, 2012	$ 134.6	$ 17.0	$ 72.5	$ 224.1

6. RELATED PARTY TRANSACTIONS

VMS has a 40% ownership interest in dpiX Holding LLC (dpiX Holding), a two-member consortium which has a 100% 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 image detectors and for its Oncology Systems On-Board Imager® (OBI), and PortalVision™ imaging products. In accordance with the dpiX Holding agreement, net losses were to be allocated to the members, in succession, until their capital accounts equaled zero, then to the members in accordance with their ownership interests. The dpiX Holding agreement also provided that net profits were to be allocated to the members, in succession, until their capital accounts equaled the net losses previously allocated, then to the members in accordance with their ownership interests.

The equity investment in dpiX Holding is accounted for under the equity method of accounting. When VMS recognizes its share of net profits or losses of dpiX Holding, profits or losses in inventory purchased from dpiX are eliminated until realized by VMS. VMS recorded income on the equity investment in dpiX Holding of $1.7 million in the three months ended June 29, 2012 and income of $0.3 million in the three months ended July 1, 2011. VMS recorded income on the equity investment in dpiX Holding of $1.2 million in the nine months ended June 29, 2012 and income of $4.5 million in the nine months ended July 1, 2011. Income and loss on the equity investment in dpiX Holding are included in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings. The carrying value of the equity investment in dpiX Holding, which was included in Other assets in the Condensed Consolidated Balance Sheets, was $46.2 million at June 29, 2012 and $46.7 million at September 30, 2011.

VMS entered into a loan agreement with dpiX in February 2009, which was amended in December 2011, under which VMS loaned $8.8 million to dpiX. The loan bears interest at prime plus 1% per annum. Interest was payable in full according to a quarterly schedule that began in April 2009. The principal balance was due and payable to VMS in installments, of which $3.4 million was due and paid in December 2011 and the balance, together with accrued and unpaid interest and all other related amounts payable, was due and payable on or before December 31, 2013. As of June 29, 2012, the amount outstanding under this loan agreement was $5.4 million, which was included in Other assets in the Condensed Consolidated Balance Sheet. As of September 30, 2011, the amount outstanding under this loan agreement was $8.8 million, which was included in Prepaid expenses and other current assets in the Condensed Consolidated Balance Sheets. The Company evaluated the collectability of its note receivable with dpiX at least on a quarterly basis, considering the timeliness of recurring payments, as well as its financial position and cash flows, and would recognize an impairment loss for any amount the Company deemed uncollectible. In July 2012, dpiX paid the outstanding amount of the loan prior to the due date of December 31, 2013.

During the three months ended June 29, 2012 and July 1, 2011, the Company purchased glass transistor arrays from dpiX totaling approximately $2.9 million and $6.4 million, respectively. Glass transistor arrays purchased from dpiX totaled approximately $10.9 million for the nine months ended June 29, 2012 and $18.7 million for the nine months ended July 1, 2011. These purchases of glass transistor arrays 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 for these periods.

7. CREDIT FACILITY

On April 27, 2012, VMS entered into a five-year credit agreement with certain lenders and Bank of America, N.A. (BofA) as administrative agent (the 2012 Credit Facility). The 2012 Credit Facility was arranged by Merrill Lynch, Pierce, Fenner & Smith Incorporated and enables the Company to borrow and have outstanding at any given time up to a maximum of $300 million. The 2012 Credit Facility includes a $50 million sub-facility for the issuance of letters of credit and permits swing

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

line loans of up to $25 million. The Company also has the right to increase the aggregate commitments under the 2012 Credit Facility by up to $200 million, provided that the lenders are willing to provide increased commitments and certain other conditions are met. The 2012 Credit Facility is secured, subject to certain limitations on the amount secured, by a pledge of stock of certain of VMS s present and future subsidiaries that are deemed to be material subsidiaries. As of June 29, 2012, VMS had pledged 65% of the voting shares that it holds in Varian Medical Systems Nederland Holdings B.V., a wholly owned subsidiary. All hedging or treasury management obligations entered into by the Company with a lender are also secured by the stock pledges. The 2012 Credit Facility must be guaranteed by certain of VMS s material domestic subsidiaries under certain circumstances. As of June 29, 2012, the 2012 Credit Facility was not guaranteed by any VMS subsidiary. The 2012 Credit Facility may be used for working capital, capital expenditures, permitted share repurchases, permitted acquisitions and other lawful corporate purposes.

Borrowings under the 2012 Credit Facility accrue interest either (i) based on a Eurodollar rate (as defined in the credit agreement), plus a margin of 1.25% to 1.5% based on a leverage ratio involving funded indebtedness and earnings before interest, taxes and depreciation and amortization (EBITDA) or (ii) based upon a base rate of the highest of (a) the federal funds rate plus 0.5%, (b) BofA s announced prime rate or (c) the Eurodollar rate plus 1%, plus a margin of 0.25% to 0.5% based on the same leverage ratio, depending on instructions from the Company. The Company also must pay a commitment fee on the unused portion of the 2012 Credit Facility at a rate from 0.25% to 0.30% based on the same leverage ratio. Swing line loans under the 2012 Credit Facility will bear interest at the base rate plus the then applicable margin for base rate loans. The Company may prepay, reduce or terminate the commitments without penalty. At June 29, 2012, a total of $165 million was outstanding under the 2012 Credit Facility with a weighted average interest rate of 1.62%. No letters of credit or swing line loans were outstanding at that date.

The credit agreement contains affirmative and negative covenants applicable to the Company that are typical for credit facilities of this type, and that are subject to materiality and other qualifications, carve-outs, baskets and exceptions. The Company has also agreed to maintain certain financial covenants, including (i) a maximum consolidated leverage ratio, involving funded indebtedness and EBITDA and (ii) a minimum cash flow coverage. For all periods presented within these condensed consolidated financial statements, the Company was in compliance with all covenants under the 2012 Credit Facility.

Prior to the 2012 Credit Facility, VMS had a credit agreement with BofA which provided for a revolving credit facility that enabled the Company to borrow and have outstanding at any given time a maximum of $300 million (the Amended BofA Credit Facility). Under the Amended BofA Credit Facility, VMS s Japanese subsidiary (VMS KK) could borrow up to 2.7 billion Japanese yen as part of the overall credit facility (the Japanese Line of Credit). VMS guaranteed the payment of the outstanding balance under the Japanese Line of Credit. The Amended BofA Credit Facility, including the Japanese Line of Credit, terminated on April 27, 2012, and was replaced with the 2012 Credit Facility.

At September 30, 2011, a total of $181 million was outstanding under the Amended BofA Credit Facility with a weighted average interest rate of 1.05%, none of which was outstanding under the Japanese Line of Credit. Up to $25 million of the Amended BofA Credit Facility could be used to support letters of credit issued on behalf of the Company, of which none were outstanding as of September 30, 2011.

The Amended BofA Credit Facility contained customary affirmative and negative covenants for facilities of this type. The Company also agreed to maintain certain financial covenants relating to (i) leverage ratios involving funded indebtedness and EBITDA, (ii) liquidity and (iii) consolidated assets. For all periods presented within these condensed consolidated financial statements, the Company was in compliance with all covenants under the Amended BofA Credit Facility.

In addition, VMS KK has an unsecured uncommitted credit agreement with Sumitomo Mitsui Banking Corporation that enables VMS KK to borrow and have outstanding at any given time a maximum of 3 billion Japanese yen (the Sumitomo Credit Facility). The Sumitomo Credit Facility will expire on February 28, 2013. Borrowings under the Sumitomo Credit Facility accrue interest based on the basic loan rate announced by the Bank of Japan plus a margin of 0.5% per annum. As of June 29, 2012, 300 million Japanese yen, or approximately $3.8 million, was outstanding under the Sumitomo Credit Facility with a weighted average interest rate of 0.67%.

15

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

8. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company measures all derivatives at fair value on the Condensed Consolidated Balance Sheets. The accounting for gains or losses resulting from changes in the fair value of those derivatives depends upon the use of the derivative and whether it qualifies for hedge accounting. Changes in the fair value of derivatives that do not qualify for hedge accounting treatment must be recognized in earnings, together with elements excluded from effectiveness testing and the ineffective portion of a particular hedge.

The fair values of derivative instruments reported on the Company s Condensed Consolidated Balance Sheets were as follows:

	Asset Derivatives			Liability Derivatives		
(In millions)	Balance Sheet Location	June 29, 2012 Fair Value	September 30, 2011 Fair Value	Balance Sheet Location	June 29, 2012 Fair Value	September 30, 2011 Fair Value
Derivatives designated as hedging instruments:						
Foreign exchange forward contracts	Prepaid expenses and other current assets	$ 0.4	$ 0.0	Accrued liabilities	$ 0.0	$ 0.0
Derivatives not designated as hedging instruments:						
Foreign exchange forward contracts	Prepaid expenses and other current assets	0.2	0.0	Accrued liabilities	0.0	0.0
Total derivatives		$ 0.6	$ 0.0		$ 0.0	$ 0.0

See Note 3, Fair Value regarding valuation of the Company s derivative instruments. Also see Note 1, Significant Accounting Policies to the Consolidated Financial Statements of the Company s 2011 Annual Report regarding credit risk associated with the Company s derivative instruments.

Cash Flow Hedging Activities

The Company has many transactions denominated in foreign currencies and addresses certain of those financial exposures through a risk management program 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 may hedge certain of the larger foreign currency transactions when they are either not denominated in the relevant subsidiary s functional currency or the U.S. dollar. These foreign currency sales transactions are hedged using foreign currency forward contracts. The Company may use other derivative instruments in the future. The Company enters into foreign currency forward contracts primarily to reduce the effects of fluctuating foreign currency exchange rates. The Company does not enter into foreign currency forward contracts for speculative or trading purposes. The foreign currency forward contracts range from one to twelve months in maturity. As of June 29, 2012, the Company did not have any foreign currency forward contracts with an original maturity greater than twelve months.

The hedges of foreign currency denominated forecasted revenues are accounted for in accordance with ASC 815, pursuant to which the Company has designated its hedges of forecasted foreign currency revenues as cash flow hedges. The Company s designated cash flow hedges de-designate when the anticipated revenues associated with the transactions are recognized and the effective portion in Accumulated other comprehensive (loss) in the Condensed Consolidated Balance Sheets is reclassified to Revenues in the Condensed Consolidated Statements of

Earnings. Subsequent changes in fair value of the derivative instrument are recorded in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings to offset changes in fair value of the resulting non-functional currency receivables. For derivative instruments that are designated and qualify as cash flow hedges under ASC 815, Derivatives and Hedging, the Company formally documents for each derivative instrument at the hedge s inception the relationship between the hedging instrument

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

(foreign currency forward contract) and hedged item (forecasted foreign currency revenues), the nature of the risk being hedged, as well as its risk management objective and strategy for undertaking the hedge. The Company records the effective portion of the gain or loss on the derivative instrument designated and qualify as cash flow hedges in Accumulated other comprehensive loss in the Condensed Consolidated Balance Sheets and reclassifies these amounts into Revenues in the Condensed Consolidated Statements of Earnings in the period during which the hedged transaction is recognized in earnings. The Company assesses hedge effectiveness both at the onset of the hedge and on an ongoing basis using regression analysis. The Company measures hedge ineffectiveness by comparing the cumulative change in the fair value of the effective component of the hedge contract with the cumulative change in the fair value of the hedged item. The Company recognizes any over performance of the derivative as ineffectiveness in Revenues, and amounts not included in the assessment of effectiveness in Cost of revenues in the Condensed Consolidated Statements of Earnings. During the three and nine months ended June 29, 2012 and July 1, 2011, the Company did not discontinue any cash flow hedges. At the inception of the hedge, the Company assesses whether the likelihood of meeting the forecasted cash flow is highly probable. As of June 29, 2012, all forecasted cash flows were still probable to occur. As of September 30, 2011, net unrealized loss on derivative instruments before tax, of $11,000, was included in Accumulated other comprehensive loss in the Condensed Consolidated Balance Sheets. As of June 29, 2012, net unrealized gain on derivative instruments, before tax, of $0.4 million, was included in Accumulated other comprehensive loss, and is expected to be reclassified to earnings over the twelve months that follow.

The Company had the following outstanding foreign currency forward contracts that were entered into to hedge forecasted revenues:

(In millions)	**Notional Value Sold June 29, 2012**
Japanese yen	$ 11.2

The following table presents the amounts, before tax, recognized in Accumulated other comprehensive income (loss) on the Condensed Consolidated Balance Sheets and in the Condensed Consolidated Statements of Earnings that are related to the effective portion of the foreign currency forward contracts designated as cash flow hedges:

	Gain (Loss) Recognized in Other Comprehensive Income (Effective Portion)				**Location of Gain (Loss) Reclassified from Accumulated Other Comprehensive Income into Net Earnings (Effective Portion)**	**Gain (Loss) Reclassified from Accumulated Other Comprehensive Income into Net Earnings (Effective Portion)**			
	Three Months Ended		**Nine Months Ended**			**Three Months Ended**		**Nine Months Ended**	
(In millions)	**June 29, 2012**	**July 1, 2011**	**June 29, 2012**	**July 1, 2011**		**June 29, 2012**	**July 1, 2011**	**June 29, 2012**	**July 1, 2011**
Foreign exchange contracts	$ (0.5)	$ 0.0	$ 0.7	$ (0.5)	Revenues	$ 0.2	$ 0.0	$ 0.3	$ (1.0)

Balance Sheet Hedging Activities

The Company also hedges balance sheet exposures from its various subsidiaries and business units where the U.S. dollar is the functional currency. The Company enters into foreign currency forward contracts to minimize the short-term impact of foreign currency fluctuations on monetary assets and liabilities denominated in currencies other than the U.S. dollar functional currency. The foreign currency forward contracts are short term in nature, typically with a maturity of approximately one month, and are based on the net forecasted balance sheet exposure. These hedges of foreign-currency-denominated assets and liabilities do not qualify for hedge accounting treatment and are not designated as hedging instruments under ASC 815. 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 rate 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 free-standing or embedded derivative instruments.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

The Company had the following outstanding foreign currency forward contracts that were either (i) entered into to hedge balance sheet exposures from its various foreign subsidiaries and business units or (ii) originally designated as cash flow hedges (primarily in Japanese yen) and were subsequently de-designated when the forecasted revenues were recognized:

	At June 29, 2012	
(In millions)	Notional Value Sold	Notional Value Purchased
Australian dollar	$ 29.8	$ 0.0
British pound	0.0	7.8
Canadian dollar	0.0	6.0
Danish krona	0.0	0.7
Euro	184.4	0.0
Indian rupee	4.4	0.0
Japanese yen	58.2	0.0
Norwegian krone	8.0	0.0
Swedish krona	2.2	0.0
Swiss franc	0.0	40.7
Totals	$ 287.0	$ 55.2

The following table presents the gains (losses) recognized in the Condensed Consolidated Statements of Earnings related to the foreign currency forward exchange contracts that are not designated as hedging instruments under ASC 815.

Location of Gain or (Loss) Recognized in Income on Derivative	Amount of Gain or (Loss) Recognized in Net Earnings on Derivative Three Months Ended		Amount of Gain or (Loss) Recognized in Net Earnings on Derivative Nine Months Ended	
(In millions)	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
Selling, general and administrative expenses	$ 6.6	$ (4.1)	$ 8.7	$ (7.1)

The gains (losses) on these derivative instruments were significantly offset by the gains (losses) resulting from the remeasurement of monetary assets and liabilities denominated in currencies other than the U.S. dollar functional currency.

Contingent Features

Certain of the Company s derivative instruments are subject to master agreements which contain provisions that require the Company, in the event of a default, to settle the outstanding contracts in net liability positions by making settlement payments in cash or by setting off amounts owed to the counterparty against any credit support or collateral held by the counterparty. The counterparty s right of set-off is not limited to the derivative instruments and applies to other rights held by the counterparty. These events of default, which are defined by the existing agreements, are primarily related to the Company s failure to pay the counterparty under the derivative instruments, voluntary or involuntary bankruptcy, the Company s default on its borrowings, and deterioration of creditworthiness of the surviving entity if the Company merges or transfers its assets or liabilities to another entity. As of June 29, 2012 and September 30, 2011, the Company did not have significant outstanding derivative instruments with credit-risk-related contingent features that were in a net liability position.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

9. COMMITMENTS AND CONTINGENCIES

Product Warranty

The following table reflects the changes in the Company s accrued product warranty:

	Nine Months Ended	
(In millions)	**June 29, 2012**	**July 1, 2011**
Accrued product warranty, at beginning of period	$ 50.1	$ 53.2
Charged to cost of revenues	41.3	32.0
Actual product warranty expenditures	(42.1)	(33.2)
Accrued product warranty, at end of period	$ 49.3	$ 52.0

Other Commitments

In September 2011, the Company, through its Swiss subsidiary, participated in a $165 million loan facility for CPTC, under which the subsidiary committed to loan up to $115 million to finance the construction and start-up operations of a proton therapy center. See Note 15, Variable Interest Entity for a detailed discussion.

In September 2011, the Company entered into a commercial agreement in which the Company agreed to resell a third party company s products. As part of that agreement, the Company agreed to make guaranteed prepayments of $67 million to that third party for orders of its products that the Company will resell to end-user customers. As of June 29, 2012, under this commercial agreement, the Company had remaining guaranteed prepayment obligations of $7 million in fiscal year 2012 and $21 million in fiscal year 2013.

Environmental Remediation Liabilities

The Company s operations and facilities, past and present, are subject to environmental laws, including laws that regulate the handling, storage, transport and disposal of hazardous substances. Certain of those laws impose cleanup liabilities under certain circumstances. In connection with those laws and certain of the Company s past and present operations and facilities, the Company oversees various environmental cleanup projects and also reimburses certain third parties for cleanup activities. Those include facilities sold as part of the Company s electron devices business in 1995 and thin film systems business in 1997. In addition, the U.S. Environmental Protection Agency (EPA) or third parties have named the Company as a potentially responsible party under the amended Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA), at sites to which the Company or the facilities of the sold businesses were alleged to have shipped waste for recycling or disposal (the CERCLA sites). In connection with the CERCLA sites, the Company to date has been required to pay only modest amounts as its contributions to cleanup efforts. Under the agreement that governs the spin-offs of Varian, Inc., which was acquired by Agilent Technologies Inc. (the successor entity hereinafter referred to as VI), and Varian Semiconductor Equipment Associates, Inc., which was acquired by Applied Materials, Inc. (the successor entity hereinafter referred to as VSEA), VI and VSEA are each obligated to indemnify the Company for one-third of the environmental cleanup costs associated with corporate, discontinued or sold operations prior to the spin-offs (after adjusting for any insurance proceeds or tax benefits received by the Company), as well as fully indemnify the Company for other liabilities arising from the operations of the business transferred to it as part of the spin-offs.

The Company spent $0.7 million and $0.5 million (net of amounts borne by VI and VSEA) during the three months ended June 29, 2012 and July 1, 2011, respectively, on environmental cleanup costs, third-party claim costs, project management costs and legal costs. The Company spent $1.2 million and $0.9 million (net of amounts borne by VI and VSEA) during the nine months ended June 29, 2012 and July 1, 2011, respectively, on such costs.

Inherent uncertainties make it difficult to estimate the likelihood of the cost of future cleanup, third-party claims, project management and legal services for the CERCLA sites and one of the Company s past facilities. Nonetheless, as of June 29, 2012, the Company estimated that, net of VI s and VSEA s indemnification obligations, future costs associated with the

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

CERCLA sites and this facility would range in total from $2.1 million to $9.5 million. The time frames over which these cleanup project costs are estimated vary, ranging from one year up to thirty years as of June 29, 2012. Management believes that no amount in that range is more probable of being incurred than any other amount and therefore accrued $2.1 million for these cleanup projects as of June 29, 2012. The accrued amount has not been discounted to present value due to the uncertainties that make it difficult to develop a single best estimate.

The Company believes it has gained sufficient knowledge to better estimate the scope and cost of monitoring, cleanup and management activities for its other past and present facilities. This, in part, is based on agreements with other parties and also cleanup plans approved by or completed in accordance with the requirements of the governmental agencies having jurisdiction. As of June 29, 2012, the Company estimated that the Company s future exposure, net of VI s and VSEA s indemnification obligations, for the costs at these facilities, and reimbursements of third party s claims for these facilities, ranged in total from $6.6 million to $36.0 million. The time frames over which these costs are estimated to be incurred vary, ranging from five years to thirty years as of June 29, 2012. As to each of these facilities, management determined that a particular amount within the range of estimated costs was a better estimate than any other amount within the range, and that the amount and timing of these future costs were reliably determinable. The best estimate within that range was $13.4 million at June 29, 2012. Accordingly, the Company has accrued $10.1 million for these costs, which represents the best estimate discounted at 4%, net of inflation. This accrual is in addition to the $2.1 million described in the preceding paragraph.

These amounts are only estimates of anticipated future costs. The amounts the Company will actually spend may be greater or less than these estimates, even as the Company believes the degree of uncertainty will narrow as cleanup activities progress. While the Company believes its reserve is adequate, as the scope of the Company s obligations becomes more clearly defined, the Company may modify the reserve, and charge or credit future earnings accordingly. Nevertheless, based on information currently known to management, and assuming VI and VSEA satisfy their indemnification obligations, management believes 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 one fiscal year.

The Company evaluates its liability for investigation and cleanup costs in light of the obligations and apparent financial strength of potentially responsible parties and insurance companies with respect to which the Company believes it has rights to indemnity or reimbursement. The Company has asserted claims for recovery of environmental investigation and cleanup costs already incurred, and to be incurred in the future against various insurance companies and other third parties. The Company receives certain cash payments in the form of settlements and judgments from defendants, insurers and other third parties from time to time. The Company has also reached an agreement with an insurance company under which that insurer has agreed to pay a portion of the Company s past and future environmental-related expenditures. The Company recorded receivables from that insurer of $2.7 million at June 29, 2012 and $3.0 million at September 30, 2011, with the respective current portion included in Prepaid expenses and other current assets and the respective noncurrent portion included in Other assets in the Condensed Consolidated Balance Sheets. The Company believes that this receivable is recoverable because it is based on a binding, written settlement agreement with what appears to be a financially viable insurance company, and the insurance company has paid the Company s claims in the past.

The availability of the indemnities of VI and VSEA will depend upon the future financial strength of VI and VSEA. Given the long-term nature of some of the liabilities, VI and VSEA may be unable to fund the indemnities in the future. It is also possible that a court would disregard this contractual allocation among the parties and require the Company to assume responsibility for obligations allocated to another party, particularly if the other party were to refuse or was unable to pay any of its allocated share. The agreement governing the spin-offs generally provides that if a court prohibits a company from satisfying its shared indemnification obligations, the indemnification obligations will be shared equally by the two other companies.

Acquisition-Related Commitments/Obligations

When the Company acquired ACCEL Instruments GmbH (ACCEL, which has since changed its name to Varian Medical Systems Particle Therapy GmbH) in January 2007, ACCEL was involved in a contract-related lawsuit, which the Company settled by agreeing to perform certain commissioning services for a proton therapy system for a fixed-price contract (the Fixed-Price Contract). In the first quarter of fiscal year 2010, the Company entered into a new contract (the New Contract) to perform certain services for a fixed price. The balance of the loss accrual related to this contingency (the New Contract) was 0.9 million as of June 29, 2012. If the actual costs related to the contingency exceed the estimated amount or if the estimated loss increases, the variances will be recognized in the Consolidated Statements of Earnings in the periods in which these variances arise.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Other Matters

From time to time, the Company is a party to or otherwise involved in legal proceedings, claims and government inspections or investigations and other legal matters, both inside and outside the United States, arising in the ordinary course of its business or otherwise. These matters include, as of June 29, 2012, a patent infringement lawsuit initiated in 2007 by the University of Pittsburgh regarding the Company s Real-time Position Management (RPM) technology. On or about December 21, 2011, the trial court presiding over the litigation entered a summary judgment order in the case finding that the Company s RPM technology was covered by some of the claims of the subject patent. The remaining issues in the litigation were then trifurcated by the trial court, and in the proceedings the jury found (i) that the Company willfully infringed the subject patent, (ii) that the Company is liable for approximately $37 million in actual damages and (iii) that the subject patent was valid. In an order dated April 25, 2012, the court enhanced damages by doubling them to approximately $74 million. In addition, the court assessed prejudgment interest to the damages award in the amount of approximately $13 million. In an order dated May 25, 2012, the court assessed damages for the period from the last time sales information was updated in the litigation, *i.e.*, March 2011, until judgment, of approximately $3 million, which was doubled to approximately $6 million. Attorneys fees of approximately $9 million will also be added to the judgment. The court also ordered the Company to pay ongoing royalties at the rates found by the jury for sales after the date of judgment. The Company has appealed the findings against it and believes that it has valid reasons for the judgment to be reversed.

The Company accrues amounts, to the extent they can be reasonably estimated, that it believes are adequate to address any liabilities related to legal proceedings and other loss contingencies that the Company believes will result in a probable loss. As of June 29, 2012, the Company had accrued an aggregate of approximately $6 million of such losses with respect to ongoing proceedings, including the University of Pittsburgh proceeding. However, such matters are subject to many uncertainties and outcomes are not predictable with assurance. The Company is unable to estimate a range of reasonably possible losses in excess of the amounts accrued with respect to such matters. There can be no assurances as to whether the Company will become subject to significant additional claims and liabilities with respect to ongoing or future proceedings. If actual liabilities significantly exceed the estimates made, the Company s consolidated financial position, results of operations or cash flows could be materially adversely affected.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

10. RETIREMENT PLANS

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

	Three Months Ended		Nine Months Ended	
(In thousands)	**June 29, 2012**	**July 1, 2011**	**June 29, 2012**	**July 1, 2011**
Defined Benefit Plans				
Service cost	$ 1,072	$ 945	$ 3,281	$ 2,713
Interest cost	1,325	1,283	4,016	3,710
Settlement gain	0	0	(161)	0
Expected return on plan assets	(1,316)	(1,251)	(3,982)	(3,622)
Amortization of prior service cost	40	38	120	113
Recognized actuarial loss	621	512	1,863	1,538
Net periodic benefit cost	$ 1,742	$ 1,527	$ 5,137	$ 4,452
Post-Retirement Benefit Plans				
Interest cost	$ 55	$ 62	$ 165	$ 186
Amortization of prior service cost	1	1	3	3
Recognized actuarial loss	21	13	63	39
Net periodic benefit cost	$ 77	$ 76	$ 231	$ 228

The Company made contributions to the defined benefit plans of $8.1 million during the nine months ended June 29, 2012. The Company currently expects total contributions to the defined benefit plans for fiscal year 2012 will be approximately $9.7 million. The Company made contributions to the post-retirement benefit plans of $0.4 million during the nine months ended June 29, 2012. The Company currently expects total contributions to the post-retirement benefit plans for fiscal year 2012 will be approximately $0.5 million.

11. INCOME TAXES

The Company s effective tax rate on earnings from continuing operations was 29.3% in the three months ended June 29, 2012, compared to 29.9% in the same period of fiscal year 2011. For the nine months ended June 29, 2012, the Company s effective tax rate on earnings from continuing operations was 28.2%, compared to 30.5% in the same period of fiscal year 2011. For both the three month and nine month periods, the decrease in the Company s effective tax rate was primarily due to a shift in the geographic mix of earnings. This was partially offset by a smaller net benefit for discrete items in the current period related to the prior period, primarily related to the release of certain liabilities for uncertain tax positions, including the expiration of the statutes of limitation in various jurisdictions and the favorable resolution of several income tax audits.

The Company s effective income tax rate differs from the U.S. federal statutory rate primarily because the Company s foreign earnings are taxed at rates that are, on average, lower than the U.S. federal rate, and because the Company s domestic earnings are subject to state income taxes.

The total amount of unrecognized tax benefits did not change by a significant amount during the nine months ended June 29, 2012; however, the amount of unrecognized tax benefits has increased as a result of positions taken during the current and prior years, and has decreased as a result of expirations of the statutes of limitation and audit settlements in various jurisdictions.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

12. STOCKHOLDERS EQUITY

Stock Repurchase Program

During the three months ended March 30, 2012, the Company settled an accelerated share repurchase agreement executed on August 25, 2011 with BofA (the August 2011 Repurchase Agreement). Pursuant to the August 2011 Repurchase Agreement, the Company paid to BofA $250 million and BofA delivered 3,849,638 shares of VMS common stock, representing approximately 85% of the shares expected to be repurchased. The remaining $37.5 million, representing approximately 15% of the initial cash payment to BofA, was recorded as an equity forward contract, which was included in Capital in excess of par value in the Condensed Consolidated Balance Sheet at September 30, 2011 and June 29, 2012. Under the terms of the August 2011 Repurchase Agreement, the specific number of shares that the Company ultimately repurchased was to be based on the volume weighted average share price of VMS common stock during the repurchase period, less a discount, such that the Company might be entitled to receive additional shares of VMS common stock from BofA or the Company might be required to deliver shares of VMS common stock or, at the Company s option, make a cash payment to BofA. The repurchase period ended in February 2012 and the Company received an additional 375,449 shares of VMS common stock upon the settlement of the August 2011 Repurchase Agreement. The market value of the shares received of $25 million was included in Capital in excess of par value as of June 29, 2012.

Including the 375,449 shares received upon the upon the settlement of the August 2011 Repurchase Agreement, the Company repurchased a total of 3,000,000 shares of VMS common stock during the nine months ended June 29, 2012, of which 1,500,000 shares were repurchased in the three months ended June 29, 2012. During the nine months ended July 1, 2011, the Company repurchased 4,178,395 shares of VMS common stock (all of which was purchased under an accelerated share repurchase agreement executed in February 2011 (the February 2011 Repurchase Agreement)), of which 630,921 shares were repurchased for no additional consideration during the three months ended July 1, 2011 in connection with the settlement of the February 2011 Repurchase Agreement. Aggregate cash payments in connection with accelerated share repurchase agreements, if any, and for shares repurchased in the open market totaled $97.0 million during the three months ended June 29, 2012 and $172.4 million during the nine months ended June 29, 2012. The Company did not make any cash payment for such transactions during the three months ended July 1, 2011. Aggregate cash payments for such transactions for the nine months ended July 1, 2011 totaled $306.1 million. All shares that were repurchased have been retired.

In February 2011, the VMS Board of Directors authorized the repurchase of 12 million shares of VMS common stock through the end of fiscal year 2012. As of June 29, 2012, 4,433,718 shares of VMS common stock remained available for repurchase under this repurchase authorization. Shares may be repurchased in the open market, in privately negotiated transactions (such as the August 2011 and similar accelerated repurchase programs) or under Rule 10b5-1 share repurchase plans, and may be made from time to time or in one or more blocks.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Comprehensive Earnings

The components of comprehensive earnings are as follows:

	Three Months Ended		Nine Months Ended	
(In thousands)	**June 29, 2012**	**July 1, 2011**	**June 29, 2012**	**July 1, 2011**
Net earnings	**$ 108,843**	**$ 98,605**	**$ 306,848**	**$ 298,173**
Other comprehensive income (loss), net of tax:				
Defined benefit pension and post-retirement benefit plans:				
Settlement loss	0	0	91	0
Amortization of prior service cost included in net periodic benefit cost	36	35	107	103
Amortization of net actuarial loss included in net periodic benefit cost	510	415	1,539	1,242
	546	450	1,737	1,345
Unrealized gain on derivatives:				
Increase (decrease) in unrealized gain	(328)	0	446	(318)
Reclassification adjustments	(111)	0	(195)	625
	(439)	0	251	307
Currency translation adjustment	(6,331)	3,194	(6,320)	7,714
Other comprehensive income (loss)	**(6,224)**	**3,644**	**(4,332)**	**9,366**
Total comprehensive earnings	**$ 102,619**	**$ 102,249**	**$ 302,516**	**$ 307,539**

13. EMPLOYEE STOCK PLANS

In February 2012, VMS s stockholders approved the further amendment of the Varian Medical Systems, Inc. 2005 Ominbus Stock Plan and its restatement as the Third Amended and Restated 2005 Omnibus Stock Plan (the Third Amended 2005 Plan) to (i) increase the number of shares available for grant under the plan by 6,000,000 shares, (ii) change the number of shares counted against the available-for-grant limit from 2.5 shares to 2.6 shares for every one share issued in connection with awards other than stock options and stock appreciation rights on a go-forward basis and (iii) extend the term of the Third Amended 2005 Plan until November 11, 2021.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

The table below summarizes the share-based compensation expense recognized under ASC 718, Compensation Stock Compensation, for stock awards under the Third Amended 2005 Plan (before and after its February 2012 amendment and restatement) and for the option component of the employee stock purchase plan shares:

	Three Months Ended		Nine Months Ended	
(In thousands, except per share amounts)	**June 29, 2012**	**July 1, 2011**	**June 29, 2012**	**July 1, 2011**
Cost of revenues Product	$ 1,107	$ 1,055	$ 3,351	$ 3,013
Cost of revenues Service contracts and other	317	392	1,184	1,610
Research and development	1,574	1,174	4,833	4,485
Selling, general and administrative	8,518	6,186	27,287	25,803
Taxes on earnings	(3,728)	(2,942)	(11,776)	(11,827)
Net decrease in net earnings	$ 7,788	$ 5,865	$ 24,879	$ 23,084
Increase (decrease) on:				
Cash flows from operating activities (1)	$ (1,661)	$ (4,282)	$ (7,805)	$ (21,768)
Cash flows from financing activities (1)	$ 1,661	$ 4,282	$ 7,805	$ 21,768

(1) Amounts represent excess tax benefits from share-based compensation.

During the three and nine months ended June 29, 2012, total share-based compensation expense recognized in earnings before taxes was $11.5 million and $36.7 million, respectively, and the total related recognized tax benefit was $3.7 million and $11.8 million, respectively. During the three and nine months ended July 1, 2011, total share-based compensation expense recognized in earnings before taxes was $8.8 million and $34.9 million, respectively, and the total related recognized tax benefit was $2.9 million and $11.8 million, respectively.

Total share-based compensation expense capitalized as part of inventory for the three and nine months ended June 29, 2012 was $0.8 million and $2.5 million, respectively. Total share-based compensation expense capitalized as part of inventory for the three and nine months ended July 1, 2011 was $0.6 million and $2.3 million, respectively.

During the nine months ended June 29, 2012, the Company granted performance units to certain employees under the Third Amended 2005 Plan (before and after its amendment and restatement). The number of shares of VMS common stock ultimately issued under the performance units at the end of a three-year performance period will depend on the Company s business performance during the three-year period against specified performance targets set by the Compensation and Management Development Committee of the Board of Directors at the beginning of the period. Subject to certain exceptions, any unvested performance unit awards are generally forfeited at the time of termination.

The fair value of options granted was estimated at the date of grant using the Black-Scholes model with the following weighted average assumptions:

	Three Months Ended		Nine Months Ended	
	June 29, 2012	**July 1, 2011**	**June 29, 2012**	**July 1, 2011**
Employee Stock Option Plans				

Expected term (in years)	4.55	5.19	4.64	4.75
Risk-free interest rate	0.7%	1.8%	0.8%	2.0%
Expected volatility	34.3%	34.5%	36.9%	35.5%
Expected dividend	0.0%	0.0%	0.0%	0.0%
Weighted average fair value at grant date	$ 19.14	$ 23.23	$ 18.75	$ 23.26

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

The option component of employee stock purchase plan shares was estimated at the date of grant using the Black-Scholes model with the following weighted average assumptions:

	Three Months Ended		Nine Months Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
Employee Stock Purchase Plan				
Expected term (in years)	0.50	0.50	0.50	0.50
Risk-free interest rate	0.1%	0.1%	0.1%	0.2%
Expected volatility	18.0%	12.6%	20.6%	11.9%
Expected dividend	0.0%	0.0%	0.0%	0.0%
Weighted average fair value at grant date	$ 12.16	$ 13.09	$ 12.38	$ 11.91

Activity under the Company s 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 30, 2011	8,424	6,917	$ 45.90		
Authorized	6,000	0	0.00		
Granted (1)	(2,673)	742	58.50		
Cancelled or expired (2)	111	(29)	55.69		
Exercised	0	(1,015)	40.60		
Balance at June 29, 2012	11,862	6,615	$ 48.08	3.8	$ 84,621
Exercisable at June 29, 2012		5,604	$ 46.56	3.4	$ 80,142

(1) The difference between the number of shares granted listed in the column headed Shares Available for Grant and the number of shares granted listed in the column headed Options Outstanding Number of Shares represents the awards of deferred stock units, restricted stock units and performance units. Deferred stock unit, restricted stock unit and performance unit awards were counted against the shares available for grant limit as 2.5 shares for every one awarded before February 9, 2012 and were counted against the shares available for grant limit as 2.6 shares for every one awarded on or after February 9, 2012. In addition, the shares available for grant limit was further adjusted to reflect a maximum payout of 1.5 shares that could be issued for each performance unit granted.

(2) The difference between the number of cancelled or expired shares listed in the column headed Shares Available for Grant and the number of cancelled or expired shares listed in the column headed Options Outstanding Number of Shares represents the cancellation of shares of restricted common stock and restricted stock units due to employee terminations.

(3) The aggregate intrinsic value represents the total pre-tax intrinsic value, which is computed based on the difference between the exercise price and the closing price of VMS common stock of $60.77 as of June 29, 2012, the last trading date of the third quarter of fiscal year 2012, and

which would have been received by the option holders had all option holders exercised and sold their options as of that date.

As of June 29, 2012, there was $11.9 million of total unrecognized compensation expense related to outstanding stock options. This unrecognized compensation expense is expected to be recognized over a weighted average period of 1.7 years.

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

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

(In thousands, except per share amounts)	Shares	Weighted Average Grant-Date Fair Value
Balance at September 30, 2011	735	$ 47.36
Granted	713	59.06
Vested	(397)	45.14
Cancelled or expired	(33)	53.49
Balance at June 29, 2012	1,018	$ 56.23

As of June 29, 2012, unrecognized compensation expense totaling $35.8 million was related to awards of restricted stock, restricted stock units, deferred stock units and performance units. This unrecognized compensation expense is expected to be recognized over a weighted average period of 1.9 years.

14. EARNINGS PER SHARE

Basic net earnings per share is computed by dividing net earnings by the weighted average number of shares of VMS 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		Nine Months Ended	
(In thousands, except per share amounts)	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
Net earnings	$ 108,843	$ 98,605	$ 306,848	$ 298,173
Weighted average shares outstanding basic	111,070	116,874	111,857	117,614
Dilutive effect of potential common shares	1,753	2,190	2,104	2,217
Weighted average shares outstanding diluted	112,823	119,064	113,961	119,831
Net earnings per share basic	$ 0.98	$ 0.84	$ 2.74	$ 2.54
Net earnings per share diluted	$ 0.96	$ 0.83	$ 2.69	$ 2.49

The Company excludes potentially dilutive common shares (consisting of shares underlying stock options and the employee stock purchase plan) from the computation of diluted weighted average shares outstanding if the per share value, either the exercise price of the awards or the sum of (a) the exercise price of the awards and (b) the amount of the compensation cost attributed to future services and not yet recognized and (c) the amount of tax benefit or shortfall 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 the shares underlying these stock awards would be antidilutive to earnings per share.

Based on this calculation, stock options to purchase 559,695 shares at an average exercise price of $59.71 per share and 47,750 shares at an average exercise price of $69.67 per share were excluded from the computation of diluted weighted average shares outstanding for the three months ended June 29, 2012 and July 1, 2011, respectively. Stock options to purchase 250,619 shares at an average exercise price of $61.92 and 41,000 shares at an average exercise price of $70.60 per share were excluded from the computation of diluted weighted average shares outstanding for the nine months ended June 29, 2012 and July 1, 2011, respectively.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

15. VARIABLE INTEREST ENTITY

During fiscal year 2011, the Company entered into a number of agreements with CPTC. CPTC is a variable interest entity that was established to finance and operate the Scripps Proton Therapy Center in San Diego, California. CPTC has raised approximately $60 million in equity and has received a $165.3 million loan facility, in which, as described below, the Company participates, to finance the construction and start-up operations of this center. Scripps Clinic Medical Group, Inc. (Scripps) will be responsible for the clinical operations of the Scripps Proton Therapy Center, which is scheduled to open in calendar year 2013.

In April 2010, the Company signed an $88 million agreement to supply a proton therapy system to CPTC. The Company began recognizing revenues under this contract in the fourth quarter of fiscal year 2011. In June 2011, the Company signed a ten-year, approximately $60 million agreement with CPTC to service the proton therapy system. No revenues have been recognized under this service agreement. In addition, in September 2011, ORIX Capital Markets, LLC (ORIX) and the Company, through its Swiss subsidiary, committed to loan up to $165.3 million to CPTC. ORIX is the loan agent for this facility and, along with CPTC and Scripps, has budgetary approval authority for the Scripps Proton Therapy Center. The Company s maximum loan commitment under this facility is $115.3 million, reflecting the Company s pro rata share of 69.75% of the obligation to fund the initial distribution and subsequent advances. As of June 29, 2012, the Company had funded $47.2 million of its $115.3 million commitment, which is reported as a current asset on the Company s Condensed Consolidated Balance Sheet. The Company s subsidiary is not obligated to fund any additional amounts to CPTC beyond the $115.3 million committed under the loan facility. The Company may sell all or a portion of its participation in this loan facility before the end of the drawdown period in 2014. Upon the sale of all or a portion of this facility, the Company will not be required to make further loan advances for the portion of the facility that is sold.

The loan, which matures in September 2015, bears interest at LIBOR plus 6.25% per annum with a minimum interest rate of 8.25% per annum. The loan can be extended for two additional one-year terms at the election of CPTC during which extensions interest will accrue at LIBOR plus 7.00% per annum with a minimum interest rate of 9.00% per annum. Interest only payments are due monthly in arrears until July 1, 2014, at which time monthly payments based on amortization of the principal balance over a 15-year period at an interest rate of 8.25% per annum become due and payable. If all or a portion of the principal is repaid on or before July 1, 2014, interest that would have been payable had the principal not been repaid early is due and payable. The Company, as one of the lenders, is entitled to certain fees, including a commitment fee of 1.5% of the loan facility commitment amount and an exit fee of 1% of the amount of principal paid, whether as a result of prepayment or maturity. The loan facility is collateralized by all of the assets of the Scripps Proton Therapy Center. In connection with the loan facility, the Company s subsidiary also shares 4% of the gross revenues of the Scripps Proton Therapy Center for 35 years. The Company s subsidiary s right of revenue sharing may be reduced upon the sale of a portion of the Company s loan. The Company did not sell any portion of its loan during the three and nine months ended June 29, 2012.

The Company has determined that CPTC is a variable interest entity and that the Company holds a significant variable interest of CPTC through its subsidiary s participation in the loan facility and its agreements to supply and service the proton therapy equipment. The Company has concluded that it is not the primary beneficiary of CPTC. The Company has no voting rights, has no approval authority or veto rights for CPTC s budget, and does not have the power to direct patient recruitment, clinical operations and management of the Scripps Proton Therapy Center, which the Company believes are the matters that most significantly affect CPTC s economic performance.

As of June 29, 2012, in addition to the $47.2 million loan to CPTC, the Company had recorded $25.7 million in accounts receivable from CPTC. As of September 30, 2011, the outstanding loan balance to CPTC was $19.2 million and the accounts receivable balance from CPTC was $15.2 million. As of June 29, 2012, the Company s exposure to loss as a result of its involvement with CPTC was limited to the carrying amounts of these assets on its Condensed Consolidated Balance Sheets.

16. STRATEGIC ARRANGEMENT

In April 2012, VMS entered into a strategic global partnership with Siemens AG (Siemens) through which, among other things, the Company and Siemens will collaborate to develop interfaces that will enable the Company s ARIA® oncology information system software to connect with Siemens linear accelerators and imaging systems. Under the agreement establishing this collaboration, the Company committed to make certain payments, including up to $10 million in fixed fees and $20 million in license fees, in the event certain product development milestones are achieved. The Company also pays for additional licenses beyond the minimum quantities set forth in the agreement. As of June 29, 2012, no amount related to achievement of product development milestones was payable under this agreement.

Table of Contents

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

In addition, pursuant to this agreement, the Company will represent Siemens diagnostic imaging products to radiation oncology clinics initially in most international markets and in North America later in calendar year 2012, and Siemens will represent the Company s equipment and software products for radiotherapy and radiosurgery within its offerings to its healthcare customers. This agreement also provides a framework for both companies to co-develop new imaging and treatment solutions in the future.

17. 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, Security and Inspection Products business and Varian Particle Therapy business are reflected in the Other category because these operating segments do not meet the criteria of a reportable operating segment. 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		Nine Months Ended	
(In millions)	**June 29, 2012**	**July 1, 2011**	**June 29, 2012**	**July 1, 2011**
Revenues				
Oncology Systems	$ 546	$ 513	$ 1,599	$ 1,473
X-ray Products	127	121	363	350
Total reportable segments	$ 673	$ 634	$ 1,962	$ 1,823
Other	32	16	89	55
Total company	$ 705	$ 650	$ 2,051	$ 1,878
Operating Earnings (Loss)				
Oncology Systems	$ 127	$ 120	$ 364	$ 368
X-ray Products	35	30	94	88
Total reportable segments	$ 162	$ 150	$ 458	$ 456
Other	(8)	(8)	(27)	(21)
Corporate	0	(1)	(5)	(6)
Total company	$ 154	$ 141	$ 426	$ 429

18. BUSINESS COMBINATIONS

On October 3, 2011, the Company acquired all of the outstanding equity of Calypso, a privately-held supplier of specialized products and software for real-time tumor tracking and motion management during radiosurgery and radiotherapy. This acquisition, which was integrated into the Company s Oncology Systems business, enables the Company to offer real-time, non-ionizing tumor tracking tools for enhancing the precision of cancer treatments. This acquisition was accounted for as a business combination. The total purchase price of $15.8 million consisted of $10.9 million of cash consideration and $4.9 million of contingent consideration at fair value. Of the purchase price, $2.5 million was preliminarily allocated to goodwill, $7.9 million to amortizable intangible assets, and $5.4 million to net assets. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and in this case is not deductible for income tax purposes.

On April 3, 2012, VMS acquired all of the outstanding equity of InfiMed, a privately-held supplier of hardware and software for processing diagnostic X-ray images. This acquisition, which was integrated into the Company s X-ray Products business, enables the Company to provide more fully integrated X-ray component solutions to its customers. This acquisition was

VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

accounted for as a business combination. The total purchase price of $20.8 million consisted of $17.1 million of cash consideration and $3.7 million of contingent consideration at fair value. Of the purchase price, $10.9 million was preliminarily allocated to goodwill, $5.4 million to amortizable intangible assets, and $4.5 million to net assets. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and in this case is deductible for income tax purposes.

These business combinations were not significant and therefore pro forma disclosures have not been presented.

Table of Contents

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 June 29, 2012 and the related condensed consolidated statements of earnings for the three-month and nine-month periods ended June 29, 2012 and July 1, 2011 and the condensed consolidated statements of cash flows for the nine-month periods ended June 29, 2012 and July 1, 2011. 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 (United States), 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 previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of September 30, 2011, and the related consolidated statements of earnings, of stockholders equity and of cash flows for the year then ended (not presented herein), and in our report dated November 23, 2011, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of September 30, 2011, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

San Jose, CA

August 7, 2012

31

Table of Contents

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 (collectively 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 (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 (SEC), or other reasons. For this purpose, statements concerning: industry or market segment outlook; market acceptance of or transition to new products or technology such as fixed field intensity-modulated radiation therapy (IMRT), image-guided radiation therapy (IGRT), volumetric modulated arc therapy, stereotactic radiotherapy, stereotactic radiosurgery, brachytherapy, software, treatment techniques, proton therapy and advanced x-ray products; future events and developments, including expectations regarding acquisitions or partnerships; growth drivers; future orders, revenues, backlog, earnings or other financial results; and any statements using the terms believe, expect, anticipate, can, may, will, should, would, c continue, grow, intended, potential, ongoing, likely, and possible or similar statements are 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

In the third quarter of fiscal year 2012, revenues increased 9% compared to the year-ago quarter, with all businesses contributing to this growth. Gross margin in the third quarter of fiscal year 2012 increased 0.5 percentage points over the year-ago quarter with a significant increase in X-ray gross margin and an improvement in Oncology Systems gross margin. In the third quarter of fiscal year 2012, net earnings per diluted share increased 16% from the year-ago quarter. We continued to operate in a challenging global environment during the third quarter of fiscal year 2012 and total net orders were flat compared to the year-ago quarter. The U.S. dollar strengthened significantly against the Euro and weakened modestly against the Japanese yen in the third quarter of fiscal year 2012 compared to the year-ago quarter so that the differences in currency exchange rates overall had an unfavorable impact on our international revenues and net orders when measured in U.S. dollars. Including $151 million in Varian Particle Therapy (VPT) backlog, our backlog at June 29, 2012 was 16% higher than at the end of the third quarter of fiscal year 2011.

Oncology Systems. Our largest business segment is Oncology Systems, which designs, manufacturers, sells and services hardware and software products for treating cancer with conventional radiotherapy, IMRT, IGRT, volumetric modulated arc therapy (an advanced form of IMRT), stereotactic body radiotherapy, stereotactic radiotherapy, stereotactic radiosurgery and brachytherapy.

Our primary goal in the Oncology Systems business is to promote the adoption of more advanced and effective cancer treatments. In our view, the fundamental market forces that drive long-term growth in our Oncology Systems business are the rising cancer incidence; technology advances and product developments that are leading to improvements in patient care; customer demand for the more advanced and effective cancer treatments that we offer; competitive conditions among hospitals and clinics to offer such advanced treatments; continued improvement in safety and cost efficiency in delivering radiation therapy; and underserved medical needs outside of the United States. We have recently seen a greater percentage of Oncology Systems net orders and revenues coming from emerging markets within our international region, such as China, Thailand, South Korea and Russia, which typically demand lower-priced products compared to developed markets. We expect that this shift in geographic mix of net orders and revenues will generally continue and may negatively impact Oncology Systems gross margin. We do not know what impact the Affordable Health Care for America Act, including the 2.3% excise tax on sales of most medical devices starting in calendar year 2013, will have on long-term growth or demand for our products and services. In addition, in July 2012, the U.S. Centers for Medicare and Medicaid Services (CMS) proposed reductions to reimbursement rates for radiation therapy in free-standing clinics in the United States. We have seen our customers decision-making process complicated by the uncertainties surrounding healthcare reform and reimbursement rates for radiotherapy and radiosurgery in the United States, and we expect this will continue.

In October 2011, we acquired Calypso Medical Technologies, Inc. (Calypso), a supplier of specialized products and software for real-time tumor tracking and motion management during radiosurgery and radiotherapy. This acquisition enables us to offer real-time, non-ionizing tumor tracking tools for enhancing the precision of cancer treatments. We expect Calypso will have a dilutive effect on our operating earnings in fiscal year 2012. In April 2012, we entered into a strategic global partnership with Siemens through which, among other things, we will represent Siemens diagnostic imaging products to radiation oncology clinics initially in most international markets and in North America later in calendar year 2012, and Siemens will represent our equipment and software products for radiotherapy and radiosurgery within its offerings to its healthcare customers. Furthermore, we and Siemens will develop interfaces that will enable our ARIA® oncology information system software to connect with Siemens linear accelerators and imaging systems, as well as co-develop new imaging and treatment solutions.

In the third quarter of fiscal year 2012, Oncology Systems North American net orders increased 4% over the year-ago quarter. During the same period, Oncology Systems international net orders decreased 1%, but increased 4% on a constant currency basis. Oncology Systems gross margin in the third quarter of fiscal year 2012 increased 0.4 percentage points over the third quarter of fiscal year 2011.

Through June 29, 2012, we had received orders for about 550 TrueBeam systems since its introduction in the second quarter of fiscal year 2010 and had about 270 systems installed or in progress.

X-ray Products. Our X-ray Products business segment, designs, manufactures and sells X-ray tubes and flat panel detectors for use in a range of applications, including radiographic or fluoroscopic imaging, mammography, special procedures and industrial applications; and X-ray tubes for use in computed tomography (CT) scanning. We continue to view the long-term fundamental growth driver for this business to be the ongoing success of key x-ray imaging original equipment manufacturers (OEMs) that incorporate our X-ray tube products and flat panel detectors into their medical diagnostic, dental, veterinary and industrial imaging systems.

On April 3, 2012, we acquired InfiMed, Inc. (InfiMed), a supplier of hardware and software for processing diagnostic X-ray images. This acquisition will enable X-ray Products to provide more fully integrated X-ray component solutions to our customers.

In the third quarter of fiscal year 2012, X-ray Products net orders decreased 1% over the year-ago quarter. Our X-Ray Products business experienced softer demand from major customers during the third quarter of fiscal year 2012. Revenues in the third quarter of fiscal year 2012 increased compared to the third quarter of fiscal year 2011. X-ray Products gross margin for the third quarter of fiscal year 2012 increased over the third quarter of fiscal year 2011 primarily due to improved quality costs for our flat panel products, cost control measures and a greater proportion of higher margin products.

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. We are currently in the process of introducing multiple new products which we believe will help sustain the growth of our X-ray Products business. In addition, changes in access to diagnostic radiology or the reimbursement rates associated with diagnostic radiology as a result of the Affordable Health Care for America Act and similar state proposals, or otherwise, could affect demand for our products in our X-ray Products business.

Other. The Other category is comprised of Security and Inspection Products (SIP), VPT, and the operations of the Ginzton Technology Center (GTC). (Please refer to Note 16, Segment Information to the Condensed Consolidated Financial Statements within this Quarterly Report on Form 10-Q) .

SIP designs, manufactures, sells and services Linatron® x-ray accelerators, imaging processing software and image detection products (including IntellX™) for cargo screening and non-destructive examination. Orders and revenues for our SIP products have been and may continue to be unpredictable as governmental agencies may place large orders with us or our OEM customers in a short time period, and then may not place any orders for a long time period thereafter.

VPT develops, designs, manufactures, sells and services products and systems for delivering proton therapy, another form of external beam radiotherapy using proton beams, for the treatment of cancer. Although proton therapy has been in clinical use for more than four decades, it has not been widely deployed due to high capital cost. Our current focus is commercializing our proton therapy system and bringing our expertise in traditional radiation therapy to proton therapy to improve its clinical utility and to reduce its cost of treatment per patient. In July 2012, the CMS proposed reductions to reimbursement rates for proton therapy in hospitals in the United States. We do not know what impact the proposed reductions would have on the growth or demand for our VPT products and services.

GTC, our scientific research facility, develops technologies that enhance our current businesses or may lead to new business areas, including technology to improve radiation therapy and x-ray imaging, as well as other technology for a variety of applications, including security and cargo screening. GTC is also actively engaged in searching for chemical or biological agents that work synergistically with radiation to improve treatment outcomes.

Revenues in our Other category increased $16 million in the third quarter of fiscal year 2012 over the year-ago quarter, with increases in both SIP and VPT revenues. Net orders in our Other category decreased $10 million primarily due to a decrease in SIP net orders.

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 Quarterly Report on Form 10-Q and 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 30, 2011 (the 2011 Annual Report), 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 accounting principles generally accepted in the United States (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, estimates and assumptions and make adjustments when facts and circumstances dictate. In addition to the accounting policies that are more fully described in the Notes to the Consolidated Financial Statements included in our 2011 Annual Report, we consider the critical accounting policies described below to be affected by critical accounting estimates. Our critical accounting policies that are affected by accounting estimates include revenue recognition, share-based compensation expense, 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 pension and post-retirement benefit plans, valuation of derivative instruments and taxes on earnings. Such accounting policies require us to use judgments, often as a result of the need to make estimates and assumptions regarding matters that are inherently uncertain, and actual results could differ materially from these estimates. For a discussion of how these estimates and other factors may affect our business, see Part II, Item 1A, Risk Factors.

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 consideration from an arrangement to the multiple elements of the arrangement, and the appropriate timing of revenue recognition are critical with respect to these arrangements to ensure compliance with GAAP.

The allocation of consideration in a multiple element arrangement is affected by the determination of whether any software deliverables that function together with other hardware components to deliver the hardware products essential functionality are considered as non-software products for purpose of revenue recognition. The allocation of consideration to each non-software deliverable is based on the assumptions we use to establish its selling price, which are based on vendor-specific objective evidence (VSOE) of selling price, if it exists, otherwise, third-party evidence of selling price, if it exists, and if not on estimated selling prices. In addition, the allocation of consideration to each software deliverable in a multiple element arrangement is affected by our judgment as to whether VSOE of its fair value exists in these arrangements.

Changes to the elements in an arrangement and the amounts allocated to each element could affect the timing and amount 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.

Table of Contents

In addition, revenues related to certain highly customized image detection systems, proton therapy systems and proton therapy system commissioning contracts are recognized in accordance with contract accounting. For contracts in which we can estimate contract costs with reasonable dependability, we recognize contract revenues under the percentage-of-completion method. Revenues recognized under the percentage-of-completion method are based on contract costs incurred to date compared with total estimated contract costs. Changes in estimates of total contract revenue, total contract cost or the extent of progress towards completion are recognized in the period in which the changes in estimates are identified. Estimated losses on contracts are recognized in the period in which the loss is identified. In circumstances in which the final outcome of a contract cannot be precisely estimated but a loss on the contract is not expected, the Company recognizes revenues under the percentage-of-completion method based on a zero profit margin until more precise estimates can be made. If and when the Company can make more precise estimates, revenues and costs of revenues are adjusted in the same period. Because the percentage-of-completion method involves considerable use of estimates in determining revenues, costs and profits and in assigning the dollar amounts to relevant accounting periods, and because the estimates must be periodically reviewed and appropriately adjusted, if our estimates prove to be inaccurate or circumstances change over time, we may be forced to adjust revenues or even record a contract loss in later peri