

VARIAN MEDICAL SYSTEMS INC

Form 10-Q

May 11, 2010

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended April 2, 2010

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-7598

**VARIAN MEDICAL SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

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<b>Delaware</b> (State or other jurisdiction of incorporation or organization)	<b>94-2359345</b> (I.R.S. Employer Identification Number)
<b>3100 Hansen Way,</b> <b>Palo Alto, California</b> (Address of principal executive offices)	<b>94304-1030</b> (Zip Code)
<b>(650) 493-4000</b> (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  No

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

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

Large accelerated filer  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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 123,538,821 shares of common stock, par value \$1 per share, outstanding as of April 30, 2010.

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**VARIAN MEDICAL SYSTEMS, INC.**

**FORM 10-Q for the Quarter Ended April 2, 2010**

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**Table of Contents****PART I****FINANCIAL INFORMATION****Item 1. Financial Statements****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS****(Unaudited)**

<b>(In thousands, except per share amounts)</b>	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>April 2, 2010</b>	<b>April 3, 2009</b>	<b>April 2, 2010</b>	<b>April 3, 2009</b>
<b>Revenues:</b>				
Product	\$ 454,353	\$ 449,320	\$ 864,550	\$ 851,461
Service contracts and other	131,218	104,271	261,927	210,799
<b>Total revenues</b>	<b>585,571</b>	<b>553,591</b>	<b>1,126,477</b>	<b>1,062,260</b>
<b>Cost of revenues:</b>				
Product	260,946	256,134	498,315	489,414
Service contracts and other	70,647	57,066	133,167	113,498
<b>Total cost of revenues</b>	<b>331,593</b>	<b>313,200</b>	<b>631,482</b>	<b>602,912</b>
<b>Gross margin</b>	<b>253,978</b>	<b>240,391</b>	<b>494,995</b>	<b>459,348</b>
<b>Operating expenses:</b>				
Research and development	38,920	36,979	77,308	73,957
Selling, general and administrative	79,502	81,183	163,044	164,416
<b>Total operating expenses</b>	<b>118,422</b>	<b>118,162</b>	<b>240,352</b>	<b>238,373</b>
<b>Operating earnings</b>	<b>135,556</b>	<b>122,229</b>	<b>254,643</b>	<b>220,975</b>
Interest income	720	877	1,528	3,139
Interest expense	(1,099)	(1,194)	(2,203)	(2,147)
<b>Earnings from continuing operations before taxes</b>	<b>135,177</b>	<b>121,912</b>	<b>253,968</b>	<b>221,967</b>
Taxes on earnings	44,063	42,554	84,079	73,030
<b>Earnings from continuing operations</b>	<b>91,114</b>	<b>79,358</b>	<b>169,889</b>	<b>148,937</b>
Loss from discontinued operations, net of taxes		(11,545)		(12,327)
<b>Net earnings</b>	<b>\$ 91,114</b>	<b>\$ 67,813</b>	<b>\$ 169,889</b>	<b>\$ 136,610</b>
<b>Net earnings (loss) per share - Basic</b>				
Continuing operations	\$ 0.74	\$ 0.64	\$ 1.38	\$ 1.20
Discontinued operations	\$	\$ (0.09)	\$	\$ (0.10)

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Net earnings per share	\$ 0.74	\$ 0.55	\$ 1.38	\$ 1.10
Net earnings (loss) per share - Diluted				
Continuing operations	\$ 0.73	\$ 0.64	\$ 1.36	\$ 1.19
Discontinued operations	\$	\$ (0.10)	\$	\$ (0.10)
Net earnings per share	\$ 0.73	\$ 0.54	\$ 1.36	\$ 1.09
Shares used in the calculation of net earnings (loss) per share:				
Weighted average shares outstanding - Basic	122,938	123,782	123,313	123,836
Weighted average shares outstanding - Diluted	124,337	124,497	124,504	124,836

*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)	April 2, 2010	October 2, 2009 <sup>(1)</sup>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 654,727	\$ 553,529
Accounts receivable, net of allowance for doubtful accounts of \$4,321 at April 2, 2010 and \$4,347 at October 2, 2009	497,320	580,918
Inventories	371,496	321,861
Prepaid expenses and other current assets	97,989	71,751
Deferred tax assets	108,068	144,392
<b>Total current assets</b>	<b>1,729,600</b>	<b>1,672,451</b>
Property, plant and equipment, net	258,479	264,060
Goodwill	207,146	210,346
Other assets	154,664	161,391
<b>Total assets</b>	<b>\$ 2,349,889</b>	<b>\$ 2,308,248</b>
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 111,610	\$ 116,093
Accrued expenses	252,882	304,402
Product warranty	49,580	50,823
Deferred revenues	131,313	130,588
Advance payments from customers	266,104	226,964
Short-term borrowings		4,445
Current maturities of long-term debt	6,515	9,005
<b>Total current liabilities</b>	<b>818,004</b>	<b>842,320</b>
Long-term debt	23,259	23,394
Other long-term liabilities	115,100	130,751
<b>Total liabilities</b>	<b>956,363</b>	<b>996,465</b>
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock of \$1 par value: 1,000 shares authorized; none issued and outstanding		
Common stock of \$1 par value: 189,000 shares authorized; 123,460 and 125,281 shares issued and outstanding at April 2, 2010 and at October 2, 2009, respectively	123,460	125,281
Capital in excess of par value	528,544	516,478
Retained earnings	773,542	696,409
Accumulated other comprehensive loss	(32,020)	(26,385)

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Total stockholders' equity	1,393,526	1,311,783
<b>Total liabilities and stockholders' equity</b>	<b>\$ 2,349,889</b>	<b>\$ 2,308,248</b>

- (1) The condensed consolidated balance sheet as of October 2, 2009 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.*

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

<b>(In thousands)</b>	<b>Six Months Ended</b>	
	<b>April 2, 2010</b>	<b>April 3, 2009</b>
<b>Cash flows from operating activities:</b>		
Net earnings	\$ 169,889	\$ 136,610
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Share-based compensation expense	16,247	21,319
Tax benefits from exercises of share-based payment awards	7,031	4,553
Excess tax benefits from share-based compensation	(5,466)	(6,022)
Depreciation	21,990	19,372
Amortization of intangible assets	1,763	1,792
Deferred taxes	2,144	(1,366)
Provision for doubtful accounts receivable	1,104	699
Net change in fair value of derivatives and underlying commitments	(2,507)	1,671
(Income) loss on equity investment in affiliate	(1,348)	15
Loss on sale of Research Instruments		8,062
Other, net	1,353	(1,631)
Changes in assets and liabilities:		
Restricted Cash		(2,340)
Accounts receivable	68,891	(66,608)
Inventories	(57,972)	(55,340)
Prepaid expenses and other current assets	(15,445)	(14,895)
Accounts payable	(3,162)	4,576
Accrued expenses	(21,503)	3,299
Deferred revenues	725	(9,904)
Product warranty	(623)	(1,941)
Advance payments from customers	39,215	19,898
Other long-term liabilities	2,262	(2,198)
Net cash provided by operating activities	224,588	59,621
<b>Cash flows from investing activities:</b>		
Purchases of property, plant and equipment	(19,022)	(29,334)
(Increase) decrease in cash surrender value of life insurance	1,392	(2,258)
Note receivable from affiliate and other, net	(71)	(6,311)
Other, net	(4,992)	(4,290)
Net cash used in investing activities	(22,693)	(42,193)
<b>Cash flows from financing activities:</b>		
Repurchases of common stock	(126,738)	(71,541)
Proceeds from issuance of common stock to employees	28,373	13,812
Excess tax benefits from share-based compensation	5,466	6,022
Employees taxes withheld and paid for restricted stock and restricted stock units	(7,269)	(2,746)
Repayments of bank borrowings	(2,625)	(7,866)
Net borrowings (repayments) under line of credit agreements	(4,402)	10,000
Other	(119)	(132)



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Net cash used in financing activities	(107,314)	(52,451)
Effects of exchange rate changes on cash and cash equivalents	6,617	12,334
Net increase (decrease) in cash and cash equivalents	101,198	(22,689)
Cash and cash equivalents at beginning of period	553,529	397,306
Cash and cash equivalents at end of period	\$ 654,727	\$ 374,617

*See accompanying notes to the condensed consolidated financial statements.*

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**VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Description of Business***

Varian Medical Systems, Inc. ( VMS ) and subsidiaries (collectively, the Company ) designs, manufactures, sells and services equipment and software products for treating cancer with radiotherapy, stereotactic radiosurgery and brachytherapy. The Company also designs, manufactures, sells and services x-ray tubes for original equipment manufacturers; 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, manufactures 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 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 October 2, 2009 (the 2009 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 presentation of the Company s financial position as of April 2, 2010 and October 2, 2009, results of operations for the three and six months ended April 2, 2010 and April 3, 2009, and cash flows for the six months ended April 2, 2010 and April 3, 2009. The results of operations for the three and six months ended April 2, 2010 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 2010 is the 52-week period ending October 1, 2010, and fiscal year 2009 was the 53-week period that ended on October 2, 2009. The fiscal quarters ended April 2, 2010 and April 3, 2009 were both 13-week periods.

***Discontinued Operations***

As discussed in Note 16 Discontinued Operations, the Company has classified the assets and liabilities of the scientific research instruments business ( Research Instruments ) of ACCEL Instruments GmbH ( ACCEL, which has since changed its name to Varian Medical Systems Particle Therapy GmbH) as discontinued operations and presented its operating results as a discontinued operation in the Condensed Consolidated Statements of Earnings for all periods presented. Because amounts related to Research Instruments in the Condensed Consolidated Balance Sheets and the Condensed Consolidated Statements of Cash Flows were not material for any period presented, the Company has not segregated them from continuing operations. Unless noted otherwise, discussion in these notes pertains to the Company s continuing operations.

***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.



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**VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**(Unaudited)**

***Fair Value of Financial Instruments***

The carrying amounts of the Company's financial instruments, including cash and cash equivalents, accounts receivable, net of allowance for doubtful accounts, accounts payable and short-term borrowings, approximate fair value due to their short maturities. The fair value of the Company's long-term debt was estimated to be \$32.2 million at April 2, 2010 and \$34.8 million at October 2, 2009. 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. 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. Accordingly, the fair value estimate presented herein is not necessarily indicative of the amount that the Company or holders of the instruments could realize in a current market exchange. The use of different assumptions and/or estimation methodologies may have a material effect on the estimated fair value.

***Revenue Recognition***

The Company's revenues are derived primarily from the sale of hardware and software products, and related services and contracts from the Company's Oncology Systems, X-ray Products, Security and Inspection Products (SIP) and Varian Particle Therapy businesses. The Company recognizes its revenues net of any value added or sales tax and net of sales discounts.

In October 2009, the Financial Accounting Standards Board (FASB) amended the scope of its software revenue guidance to exclude tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality. In October 2009, the FASB also amended its accounting guidance for multiple deliverable revenue arrangements to provide updated guidance on whether multiple deliverables in a revenue arrangement exist, how the deliverables in an arrangement should be separated and how the consideration should be allocated. This guidance requires an entity to allocate consideration in an arrangement using estimated selling prices (ESP) of deliverables if a vendor does not have vendor-specific objective evidence (VSOE) of selling price or third-party evidence of selling price (TPE), eliminates the use of the residual method and requires an entity to allocate consideration using the relative selling price method.

At the beginning of its second quarter of fiscal year 2010, the Company elected to early adopt the amended software revenue guidance and amended multiple deliverable revenue arrangement guidance on a prospective basis as of the beginning of fiscal year 2010 and has applied the amended guidance for revenue arrangements originating or materially modified after October 2, 2009. The adoption of the new accounting guidance did not have a material impact on the Company's previously reported financial position, results of operations and cash flows. The guidance does not change the units of accounting for the Company's revenue arrangements for its existing product and service offerings as of the adoption date. However, as the Company's future hardware and software product and service offerings may become more complex and interconnected, revenue recognition for multiple element arrangements under the new guidance could differ materially from the results under prior authoritative guidance. The Company is currently unable to determine the effect that the new guidance could have on its future revenue recognition as the Company's products and service offerings evolve.

Many of the Company's revenue arrangements consist of multiple deliverables of its software and non-software products, as well as related services. In Oncology Systems, the linear accelerators are often sold with hardware and software accessory products that enhance efficiency and enable delivery of advanced radiotherapy and radiosurgery treatments. Many of the Oncology Systems hardware and software accessory products are also sold on a stand-alone basis. The X-ray Products business generally sells its x-ray tubes and flat panel detectors on a stand-alone basis. However, the X-ray Products business occasionally sells its flat panel detectors and x-ray tubes as a package that is optimized for digital x-ray imaging. While SIP products are generally sold on a stand-alone basis, SIP occasionally sells its Linatron<sup>®</sup> x-ray accelerators together with its imaging processing software and image detection products to OEM customers who incorporate them into their inspection systems. Service contracts are often sold with Oncology Systems products, as well as with certain products in the X-ray Products and SIP businesses. As discussed below, certain of the Oncology Systems and SIP products are sold with



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**VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**(Unaudited)**

installation obligations. Delivery of different elements in a revenue arrangement often span more than one reporting period. For example, a linear accelerator may be delivered in a reporting period but the related installation is completed in a later period. Revenue related to service contracts usually starts after the expiration of the warranty period for non-software product or upon acceptance for software products.

For arrangements with multiple elements that were entered into prior to fiscal year 2010, the Company allocated revenue to each element based on the prior authoritative guidance. For hardware products, the Company allocated revenue to each element based on its relative fair value and recognized the allocated revenue for each delivered element provided that it had value to the customer on a stand-alone basis. For software products (which includes software and non-software deliverables for which a software deliverable is essential to its functionality), the Company allocated revenue to each element based on VSOE of its fair value. In the absence of VSOE of its fair value for a delivered element, the Company first allocated revenue to the undelivered element based on the fair value of the undelivered elements and the residual revenue to the delivered elements, provided that the undelivered software element is not essential to the functionality of the delivered element. The Company limited the amount of revenue recognition for delivered elements to the amount that was not contingent on the future delivery of additional products or services.

For a multiple element arrangement that includes software and non-software deliverables entered into or materially modified after October 2, 2009, the Company first allocates revenues among the software and non-software deliverables on a relative selling price basis. The amounts allocated to the non-software products and software are accounted for as follows:

**Non-software Products**

For arrangements entered into or materially modified after October 2, 2009, non-software products include hardware products as well as software components that function together with the hardware components to deliver the product's essential functionality. Except as described below under Service Contracts and Other, the Company recognizes revenues for non-software products when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable and collectability is reasonably assured.

For multiple element revenue arrangements that involve non-software products, a delivered non-software element is considered as a separate unit of accounting when it has stand-alone value and there is no customer-negotiated refund or return rights for the delivered element. The allocation of revenue is determined at the inception of the arrangement to all deliverables based on their relative selling prices. The selling price for each deliverable is determined using VSOE of selling price, if it exists; otherwise, TPE. If neither VSOE of selling price nor TPE exists for a deliverable, the Company uses the deliverable's ESP.

The Company's non-software products have stand-alone value because they are sold separately. Production installation, which is a standard process and does not involve changes to the features or capabilities of the Company's products, is considered as a separate unit of accounting. Installation of Oncology Systems and SIP non-software products involves the Company's testing of each product at its factory prior to the product's delivery to ensure that the product meets the Company's published specifications. Once these tests establish that the specifications have been met, the product is then disassembled and shipped to the customer's site as specified in the customer contract. Risk of loss is transferred to the customer either at the time of shipment or delivery, depending upon the shipping terms of the contract. At the customer's site, the product is reassembled, installed and retested in accordance with the Company's installation procedures to ensure and demonstrate compliance with the Company's published specifications for that product.

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



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**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)**

The Company establishes VSOE of selling price based on the price charged for a deliverable when sold separately and, for a deliverable not yet being sold separately, the price established by management having the relevant authority. As discussed above, many products are sold in stand-alone arrangements and accordingly have VSOE of selling price. Service contracts are sold separately through renewal of annual contracts. The Company establishes TPE generally by evaluating the Company's and competitors' largely interchangeable competitor products or services in stand-alone sales to similarly situated customers. The TPE for product installation is determined based on the estimated labor hours and the prevailing hourly rate charged by the Company's service organization, as well as the prices charged by outside vendors for installation of the Company's products. For certain products for which the Company is not able to establish VSOE of selling prices or TPE, ESPs are used as the basis of their selling prices. The Company estimates selling prices following an established process that considers market conditions including competitor product offerings and pricing strategies, as well as internal factors such as historical pricing practices and margin objectives. The establishment of product and service ESPs is controlled and reviewed by the appropriate level of management in all of the Company's businesses.

The Company limits the amount of revenue recognized for delivered items to the amount that is not contingent upon the delivery of additional products or services. For Oncology Systems and SIP non-software products with installation obligations, the Company recognizes as revenues a portion of the product purchase price upon transfer of risk of loss and defers revenue recognition on the portion associated with product installation until acceptance, provided that all other criteria for revenue recognition have been met. The portion deferred is the greater of the relative selling price of the installation services for such products or the amount of payment contractually linked to the acceptance. However, when the entire purchase price for the non-software product is conditioned upon acceptance, the Company defers all revenues until acceptance.

The Company does not have installation obligations for x-ray tubes, digital image detectors, spare parts and certain hardware products in Oncology Systems and the SIP business. For the products that do not include installation obligations, the Company recognizes revenues upon the transfer of risk of loss, which is either at the time of shipment or delivery, depending upon the shipping terms of the contract, provided that all other revenue recognition criteria have been met.

**Software Products**

Except as described below under Service Contracts and Other, the Company recognizes revenues for software products in accordance with the software revenue recognition guidance. The Company recognizes license revenues when all of the following criteria have been met: persuasive evidence of an arrangement exists, the vendor's fee is fixed or determinable, collection of the related receivable is probable, delivery of the product has occurred and the Company has received from the customer an acceptance form acknowledging installation and substantial conformance with the Company's specifications (as set forth in the user manual) for such product, or upon verification of installation when customer acceptance is not required to be received, or upon the expiration of an acceptance period, provided that all other criteria for revenue recognition have been met.

Revenues earned on software arrangements involving multiple elements are allocated to each element based on VSOE of fair value, which is based on the price charged when the same element is sold separately. In instances when evidence of VSOE of fair value of all undelivered elements exists, but evidence does not exist for one or more delivered elements, revenues are recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. Revenue allocated to maintenance and support is recognized ratably over the maintenance term (typically one year).

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





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**VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**(Unaudited)**

The Company does not have installation obligations for certain brachytherapy and SIP software products. For software products that do not include installation obligations, the Company recognizes revenues upon the transfer of risk of loss, which is either at the time of shipment or delivery, depending upon the shipping terms of the contract, provided that all other criteria for revenue recognition have been met.

**Service Contracts and Other**

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

Revenues related to certain proton therapy commissioning service contracts and highly customized image detection systems are recognized under the percentage-of-completion method in accordance with contract accounting. Revenues recognized under the percentage-of-completion method are primarily based on contract costs incurred to date compared with total estimated contract costs. Estimated losses on contracts are charged to cost of sales in the period when the loss is identified.

**Advance Payments from Customers**

Except for government tenders, group purchases and orders with letters of credit, the Company typically requires its customers to provide a down payment prior to transfer of risk of loss of ordered products or an advance payment prior to performance under service contracts. These payments are recorded as Advance payments from customers in the Condensed Consolidated Balance Sheets.

**Deferred Revenue**

Deferred revenue includes (i) the amount equal to the greater of the fair value of the installation services for hardware products or the amount of the payment that is contractually linked to acceptance and (ii) the entire sale price applicable to products shipped and billable but for which installation and/or final acceptance have not been completed. Deferred costs associated with deferred revenues are included in Inventories in the Condensed Consolidated Balance Sheets.

***Recent Accounting Pronouncements***

In December 2008, the FASB issued new standards under Accounting Standards Codification (ASC 715-20), which provides guidance on an employer's disclosure about plan assets of a defined benefit pension or other post-retirement plan and requires employers to disclose information about fair value measurements of plan assets. The new standards under ASC 715-20 will be effective for the Company as of the end of fiscal year 2010. The adoption of these new standards concerns disclosure only and the Company does not expect it to have an impact on the Company's consolidated financial position, results of operations or cash flows.

In June 2009, the FASB issued the consolidation guidance for variable-interest entities to replace the quantitative-based risks and rewards calculation for determining which enterprise, if any, has a controlling financial interest in a variable-interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable-interest entity that most significantly impact the entity's economic performance. These new standards will be effective for the Company in the first quarter of fiscal year 2011. The Company is currently assessing the potential impact, if any, these new standards may have on its consolidated financial position, results of operations and cash flows.

In March 2010, the FASB issued the guidance related to the Milestone Method of Revenue Recognition (ASU 2010-17), which recognizes the milestone method as an acceptable revenue recognition method for substantive milestones in research or development transaction. ASU 2010-17 is effective in fiscal years beginning on or after June 15, 2010, with early adoption permitted. The Company is currently assessing the potential impact, if any, ASU 2010-17 may have on its consolidated financial position, results of operations and cash flows.



**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)****2. BALANCE SHEET COMPONENTS:**

The components of inventories were as follows:

(In millions)	April 2, 2010	October 2, 2009
<b>Inventories:</b>		
Raw materials and parts	\$ 215.0	\$ 183.1
Work-in-progress	50.8	54.7
Finished goods	105.7	84.1
<b>Total inventories</b>	<b>\$ 371.5</b>	<b>\$ 321.9</b>

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

(In millions)	April 2, 2010	October 2, 2009
Long-term income taxes payable	\$ 55.1	\$ 67.8
Other	60.0	63.0
<b>Total other long-term liabilities</b>	<b>\$ 115.1</b>	<b>\$ 130.8</b>

The Other category of other long-term liabilities primarily consisted of accruals for environmental costs, accrued pension and post-retirement benefits, deferred income tax liabilities and deferred rental income.

**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.

The Company's financial assets and liabilities are valued using Level 1 and Level 2 inputs. Level 1 instrument valuations are obtained from quotes for transactions in active exchange markets involving identical assets. Level 2 instrument valuations include valuations obtained from

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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. As of April 2, 2010, the Company did not have any financial assets or liabilities without observable market values that would require a high level of judgment to determine fair value (Level 3 instruments). For the three and six months ended April 2, 2010, there were no significant transfers of assets or liabilities into or out of Level 1 and Level 2 fair value measurements.

**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)**

Effective October 3, 2009, the Company adopted the provisions of ASC 820, which establishes a framework for measuring fair value in GAAP, for nonfinancial assets and liabilities and the adoption did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

The Company has segregated all assets and liabilities that are measured at fair value on a recurring basis (at least annually) into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value at the measurement date in the table below.

**Assets/Liabilities Measured at Fair Value on a Recurring Basis**

The following tables present the Company's assets that are measured at fair value on a recurring basis. There were no liabilities that were measured at fair value as of April 2, 2010 and October 2, 2009.

Type of Instruments (In millions)	Fair Value Measurement Using			Total Balance
	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<b>Assets at April 2, 2010:</b>				
Money market funds	\$ 41.7	\$	\$	\$ 41.7
Derivative assets		3.6		3.6
Total assets measured at fair value	\$ 41.7	\$ 3.6	\$	\$ 45.3
<b>Assets at October 2, 2009:</b>				
Money market funds	\$ 85.0	\$	\$	\$ 85.0
Total assets measured at fair value	\$ 85.0	\$	\$	\$ 85.0

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## VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Line Item in Condensed Consolidated Balance Sheet (In millions)	Fair Value Measurement Using			Total Balance
	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<b>Assets at April 2, 2010:</b>				
Cash and cash equivalents	\$ 40.7	\$	\$	\$ 40.7
Prepaid expenses		3.6		3.6
Other assets	1.0			1.0
<b>Total assets measured at fair value</b>	<b>\$ 41.7</b>	<b>\$ 3.6</b>	<b>\$</b>	<b>\$ 45.3</b>
<b>Assets at October 2, 2009:</b>				
Cash and cash equivalents	\$ 84.0	\$	\$	\$ 84.0
Other assets	1.0			1.0
<b>Total assets measured at fair value</b>	<b>\$ 85.0</b>	<b>\$</b>	<b>\$</b>	<b>\$ 85.0</b>

**4. GOODWILL AND INTANGIBLE ASSETS**

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

(In millions)	April 2, 2010	October 2, 2009
<b>Intangible Assets:</b>		
Acquired existing technology	\$ 20.6	\$ 20.8
Patents, licenses and other	18.4	15.2
Customer contracts and supplier relationship	10.4	10.4
Accumulated amortization	(38.9)	(37.2)
Net carrying amount	\$ 10.5	\$ 9.2

Amortization expense for intangible assets was \$0.8 million and \$0.9 million for the three months ended April 2, 2010 and April 3, 2009, respectively, and \$1.7 million and \$1.8 million for the six months ended April 2, 2010 and April 3, 2009, respectively. The Company estimates amortization expense on a straight-line basis for the remaining six months of fiscal year 2010, fiscal years 2011 through 2014 and thereafter, to be as follows (in millions): \$1.6, \$2.7, \$1.8, \$1.4, \$0.6 and \$2.4, 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 for the six months ended April 2, 2010:

(In millions)	Oncology Systems	X-ray Products	Other	Total
Balance at October 2, 2009	\$ 126.7	\$ 2.7	\$ 80.9	\$ 210.3
Payment or accrual of contingent consideration		1.5		1.5
Foreign currency translation adjustments			(4.7)	(4.7)
Balance at April 2, 2010	\$ 126.7	\$ 4.2	\$ 76.2	\$ 207.1

**5. RELATED PARTY TRANSACTIONS**

In fiscal years 1999 and 2000, VMS invested a total of \$5 million in a three member consortium for a 20% ownership interest in dpiX Holding LLC ( dpiX Holding ), which in turn invested \$25 million for an 80.1% ownership interest in dpiX LLC ( dpiX ), a supplier of amorphous silicon based thin-film transistor arrays ( flat panels ) for the Company's X-ray Products digital image detectors and for its Oncology Systems On-Board Imager® ( OBI ), and PortalVision imaging products. VMS had the right to appoint one manager of the five person board of managers. In accordance with the dpiX Holding agreement, net losses were to be allocated to the three members, in succession, until their capital accounts equaled zero, then to the three members in accordance with their ownership interests. The dpiX Holding agreement also provided that net profits were to be allocated to the three members, in succession, until their capital accounts equaled the net losses previously allocated, then to the three members in accordance with their ownership interests.

In September 2004, VMS acquired another member's 20% ownership interest in dpiX Holding for \$1 million. As a result, VMS has the right to appoint two managers of the five person board of managers and its ownership interest in dpiX Holding increased to 40% with the remaining 60% being held by the other original member. When VMS acquired this additional 20% ownership interest, the capital account of the selling member was nearly zero because it was the first in the consortium to be allocated losses. As a result, when dpiX Holding recorded net profits after VMS acquired the additional 20% ownership interest, VMS was the first to be allocated net profits to recover previously allocated losses.

The 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 in inventory purchased from dpiX are eliminated until realized by VMS. VMS recorded a gain on the equity investment in dpiX Holding of \$0.9 million in the three months ended April 2, 2010 and a loss of \$8,000 in the three months ended April 3, 2009. VMS recorded a gain on the equity investment in dpiX Holding of \$1.3 million in the six months ended April 2, 2010 and a loss of \$15,000 in the six months ended April 3, 2009. Income and losses on the equity investment in dpiX Holding are included in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings.

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

In February 2008, VMS agreed to loan \$1.6 million to dpiX, with the loan bearing interest at prime plus 1% per annum. The note receivable from dpiX was \$1.6 million at October 2, 2009, with current portion included in Prepaid expense and other current assets and the long-term portion included in Other Assets in the Condensed Consolidated Balance Sheets. The principal balance was paid in full in January 2010.



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In February 2009, VMS agreed to loan an additional \$14 million to dpiX in four separate installments. The loan bears interest at prime plus 1% per annum. The principal balance is due and payable to VMS in four installments beginning in December 2011; interest is payable in full according to a quarterly schedule which began in April 2009; and the entire principal balance, together with accrued and unpaid interest thereon and all other related amounts payable thereunder, is due and payable on September 10, 2012. As of April 2, 2010, VMS had loaned \$8.8 million to dpiX under this loan agreement.

**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)**

The current portion of the note receivable was included in Prepaid expense and other current assets and the long-term portion was included in Other Assets in the Condensed Consolidated Balance Sheets.

In March 2006, VMS and the other member of dpiX Holding agreed to invest an aggregate \$92 million in dpiX Holding, with each member's contribution based on its percentage ownership interest in dpiX Holding, for dpiX to acquire and construct a manufacturing facility in Colorado to increase its production capacity. As of April 2, 2010 and October 2, 2009, VMS's contribution of \$36.8 million to dpiX Holding for the Colorado manufacturing facility was included in Other assets in the Condensed Consolidated Balance Sheets.

During the three months ended April 2, 2010 and April 3, 2009, the Company purchased glass transistor arrays from dpiX totaling approximately \$6.4 million and \$6.4 million, respectively. Glass transistor arrays purchased from dpiX totaled \$19.5 million for the six months ended April 2, 2010 and \$14.2 million for the six months ended April 3, 2009. These purchases of flat panels are included as a component of Inventory in the Condensed Consolidated Balance Sheets and Cost of revenues - product in the Condensed Consolidated Statements of Earnings for these periods.

**6. PRODUCT WARRANTY**

The following table reflects the changes in the Company's accrued product warranty during the six months ended April 2, 2010 and April 3, 2009:

(In millions)	Six Months Ended	
	April 2, 2010	April 3, 2009
Accrued product warranty, at beginning of period	\$ 50.8	\$ 51.1
Charged to cost of revenues	24.6	27.9
Actual product warranty expenditures	(25.8)	(30.1)
Accrued product warranty, at end of period	\$ 49.6	\$ 48.9

**7. CREDIT FACILITY**

In July 2007, VMS entered into a credit agreement with Bank of America, N.A. ( BofA ) providing for an unsecured revolving credit facility that enabled the Company to borrow and have outstanding at any given time a maximum of \$100 million (the BofA Credit Facility ). On November 10, 2008, VMS amended and restated the BofA Credit Facility to increase the credit facility to \$150 million and collateralize a portion of the credit facility with a pledge of stock of certain of VMS's present and future subsidiaries that are deemed to be material subsidiaries. As of April 2, 2010, VMS had pledged to BofA 65% of the voting shares that it holds in Varian Medical Systems Nederland B.V., a wholly-owned subsidiary.

On July 14, 2009, the Company further amended and restated the credit facility (the Amended BofA Credit Facility ) to enable VMS's Japanese subsidiary ( VMS KK ) to borrow up to 2.7 billion Japanese Yen as part of the overall credit facility (the Japanese Line of Credit ). At any time amounts are outstanding under the Japanese Line of Credit, the full borrowing capacity is deemed committed for use in Japan and therefore the maximum amount VMS can otherwise borrow under the Amended BofA Credit Facility will be reduced by \$30 million to \$120 million. VMS guarantees the payment of the outstanding balance under the Japanese Line of Credit.

The Amended BofA Credit Facility may be used for working capital, capital expenditures, permitted acquisitions and other lawful corporate purposes. Borrowings under the Japanese Line of Credit can be used by VMS KK for refinancing certain intercompany debts, working capital,

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capital expenditures and other lawful corporate purposes. Borrowings under the Amended BofA Credit Facility (outside of the Japanese Line of Credit) accrue interest either (i) based on the London Inter Bank Offered Rate ( LIBOR ) plus a margin of 1.25% to 1.50% based on a leverage ratio involving funded indebtedness and earnings before interest, taxes, depreciation and amortization ( EBITDA ) or (ii) based upon a base rate of either the federal funds rate plus 0.5% or BofA s announced prime rate, whichever is greater, minus a margin of 0.5% to 0% based on a leverage ratio involving funded indebtedness and EBITDA, depending upon the Company s instructions to BofA. The Company may select borrowing periods of one, two, three or six months for advances based on the LIBOR rate. Interest

**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)**

rates on advances based on the base rate are adjustable daily. Under the Amended BofA Credit Facility, the Company paid commitment fees at an annual rate of 0.2% to 0.3% based on a leverage ratio involving funded indebtedness and EBITDA. Borrowings under the Japanese Line of Credit accrue interest at the basic loan rate announced by the Bank of Japan plus a margin of 1.25% to 1.50% based on a leverage ratio involving funded indebtedness and EBITDA. The Amended BofA Credit Facility will expire, if not extended by mutual agreement of VMS and BofA, on November 10, 2011. The Japanese Line of Credit will expire on November 10, 2010.

As of April 2, 2010, there was no outstanding balance under the Amended BofA Credit Facility. As of October 2, 2009, there was no outstanding balance under the Amended BofA Credit Facility other than \$4.4 million outstanding under the Japanese Line of Credit with a weighted average interest rate of 1.55%. Up to \$25 million of these facilities could also be used to support letters of credit issued on behalf of the Company, of which none were outstanding as of April 2, 2010 and October 2, 2009.

The Amended BofA Credit Facility contains customary affirmative and negative covenants for facilities of this type. The Company has 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, the Company was in compliance with all covenants.

**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 Company's derivative instruments are recorded at their fair value in Prepaid expenses and other current assets and Accrued expenses on the Company's Condensed Consolidated Balance Sheets.

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

(In millions)	Asset Derivatives			Liability Derivatives		
	Balance Sheet Location	April 2, 2010 Fair Value	October 2, 2009 Fair Value	Balance Sheet Location	April 2, 2010 Fair Value	October 2, 2009 Fair Value
Derivative designated as hedging instruments:						
Foreign exchange forward contracts	Prepaid Expenses	\$ 3.6	\$	Accrued liabilities	\$	\$
<b>Total derivatives</b>		<b>\$ 3.6</b>	<b>\$</b>		<b>\$</b>	<b>\$</b>

See Note 3, Fair Value and Valuation of Derivative Instruments under Critical Accounting Estimates in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations regarding valuation of the Company's derivative instruments. Also see Note 1, Significant Accounting Policies to the Consolidated Financial Statements in the Company's 2009 Annual Report regarding credit risk associated with the Company's derivative instruments.

**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)*****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 not transacted in the relevant subsidiary's functional currency. These foreign currency sales transactions are hedged using forward exchange contracts. The Company may use other derivative instruments in the future. The Company enters into foreign currency forward exchange contracts primarily to reduce the effects of fluctuating foreign currency exchange rates. The Company does not enter into forward exchange contracts for speculative or trading purposes. The forward exchange contracts range from one to twelve months in maturity. As of April 2, 2010, the Company did not have any forward exchange 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. For derivative instruments that are designated and qualify as cash flow hedges under ASC 815, the Company formally documents for each derivative contract at the hedge's inception the relationship between the hedging instrument (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 in Accumulated other comprehensive income (loss) and reclassifies these amounts into Revenues 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 hedge contract with the cumulative change in the fair value of the hedged item. The Company recognizes any ineffective portion of the hedge 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 six months ended April 2, 2010 and the three and six months ended April 3, 2009, there were no material gains or losses due to hedge ineffectiveness of cash flow hedges and the Company did not discontinue any cash flow hedges that had a material impact on the Company's results of operations. At the inception of the hedge, the Company assesses whether the likelihood of meeting the forecasted cash flow is highly probable. As of April 2, 2010, all forecasted cash flows were still probable to occur. As of October 2, 2009, there was no net unrealized gain or loss on derivative instruments included in Accumulated other comprehensive income (loss). As of April 2, 2010, net unrealized gain on derivative instruments of \$1.1 million, before tax, was included in Accumulated other comprehensive income (loss), and is expected to be reclassified to net earnings over the next twelve months.

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

<b>(In millions)</b>	<b>Notional Value Sold April 2, 2010</b>
Euro	\$ 38.2
Japanese yen	46.1
	<b>\$ 84.3</b>

**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)**

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

(In millions)	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		Six Months Ended			Three Months Ended		Six Months Ended	
	April 2, 2010	April 3, 2009	April 2, 2010	April 3, 2009		April 2, 2010	April 3, 2009	April 2, 2010	April 3, 2009
Foreign exchange contracts	\$ 0.6	\$ 4.7	\$ 1.8	\$ 8.4	Revenues	\$ 0.7	\$ 2.2	\$ 0.7	\$ 3.4

The following table presents the amounts recognized in the Condensed Consolidated Statement of Earnings that are related to (i) the ineffective portion of the cash flow hedges and (ii) the amount excluded from effectiveness testing of the cash flow hedges:

(in millions)	Location of gain (loss) recognized	Three Months Ended		Six Months Ended	
		April 2, 2010	April 3, 2009	April 2, 2010	April 3, 2009
Ineffective portion of cash flow hedges - Gain (Loss)	Revenues	\$	\$	\$	\$
Amount excluded from assessment of effective of cash flow hedges - Gain (Loss)	Cost of Revenues	\$	\$ (0.1)	\$	\$ (0.1)

**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 exchange 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 exchange contracts are short term in nature, typically with 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 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.

**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)**

As of April 2, 2010, the Company had the following outstanding foreign exchange forward contracts that were entered into to hedge balance sheet exposures from its various foreign subsidiaries and business units:

(In millions)	Notional Value Sold	Notional Value Purchased
Australian dollar	\$ 11.3	\$
British pound		7.5
Canadian dollar	8.1	
Danish krone		3.8
Euro	127.2	
Indian rupee	2.0	
Japanese yen	83.5	
Swiss franc		40.1
<b>Totals</b>	<b>\$ 232.1</b>	<b>\$ 51.4</b>

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		Six Months Ended	
	April 2, 2010	April 3, 2009	April 2, 2010	April 3, 2009
(In millions) Selling, general and administrative expenses	\$ 8.8	\$ 5.3	\$ 12.4	\$ 13.2

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 certain currencies other than the U.S. dollar functional currency.

**Contingent Features**

Certain of the Company's derivative instruments are subject to a master netting agreement which contains 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. Pursuant to the master netting agreement, an event of default includes the Company's failure to pay the counterparty under the derivative instruments, voluntary or involuntary bankruptcy, the Company's failure to repay an aggregate of \$25 million or more in debts, and deterioration of creditworthiness of the surviving entity when the Company merges or transfers its assets or liabilities to another entity. As of April 2, 2010 and October 2, 2009, the Company did not have significant outstanding derivative instruments with credit-risk-related contingent features that were in a net liability position.

**9. COMMITMENTS AND CONTINGENCIES****Commitments**

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In October 2008, VMS consummated an agreement with Varian, Inc. ( VI ), under which VI would surrender its sublease of a building containing approximately 210,000 square feet of floor space and the related leasehold interest for the land. The term of this sublease expires in the year 2056. This building, which is located adjacent to the Company s corporate



**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)**

headquarters in Palo Alto, California, is intended to support the growth of the Company's operations and its longer term objective of co-locating certain of its operations. Pursuant to this agreement, VI agreed to surrender the space in the building to the Company over a period which began in October 2008 and which ends in June 2010 and the Company agreed to pay VI an aggregate of \$21 million in cash and assume the obligations of sublessor under a below-market rate sublease to a third party for a portion of the building. As of April 2, 2010, \$5 million had been paid to VI pursuant to this agreement and the remaining \$16 million will be payable in June 2010.

***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 VI and Varian Semiconductor Equipment Associates, Inc. (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 \$0.2 million and \$0.3 million (net of amounts borne by VI and VSEA) during the three months ended April 2, 2010 and April 3, 2009, respectively, on environmental cleanup costs, third-party claim costs, project management costs and legal costs. The Company spent \$0.4 million (net of amounts borne by VI and VSEA) during each of the six months ended April 2, 2010 and April 3, 2009 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 April 2, 2010, the Company estimated that, net of VI and VSEA's indemnification obligations, future costs associated with the CERCLA sites and this facility would range in total from \$2.8 million to \$7.1 million. The time frames over which these cleanup project costs are estimated vary, ranging from 1 year up to 30 years as of April 2, 2010. Management believes that no amount in that range is more probable of being incurred than any other amount and therefore accrued \$2.8 million for these cleanup projects as of April 2, 2010. 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 April 2, 2010, 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 \$7.1 million to \$35.9 million. The time frames over which these costs are estimated to be incurred vary, ranging from 1 year to 30 years as of April 2, 2010. 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 \$15.4 million at April 2, 2010. Accordingly, the Company has accrued \$11.2 million for these costs, which represents the best estimate discounted at 4%, net of inflation. This accrual is in addition to the \$2.8 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 reserves, and charge or credit future earnings accordingly. Nevertheless, based on information currently known to management, and assuming VI and VSEA satisfy

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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.

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**VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**(Unaudited)**

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 \$2.8 million both at April 2, 2010 and October 2, 2009, which were 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 in January 2007, ACCEL was involved in a contract-related lawsuit, which the Company settled by agreeing to perform certain services for a fixed price contract (the Fixed Price Contract). As of October 2, 2009, the Company had recorded a loss accrual of \$7.6 million in relation to 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 and the Company recorded a loss accrual of \$0.9 million in connection with the New Contract. As of April 2, 2010, the balance of the loss accrual related to this contingency (the New Contract) was \$0.6 million. 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 Statement of Earnings in the periods these variances arise.

***Other Matters***

The Company is involved, from time to time, in legal proceedings, claims and government inspections or investigations both in and outside the United States, arising in the ordinary course of its business. Such matters are subject to many uncertainties and outcomes are not predictable with assurance. 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. While there can be no assurances as to the ultimate outcome of any legal proceeding or other loss contingency involving the Company, management does not believe any pending matter will be resolved in a manner that would have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

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## 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:

(In thousands)	Three Months Ended		Six Months Ended	
	April 2, 2010	April 3, 2009	April 2, 2010	April 3, 2009
<b>Defined Benefit Plans</b>				
Service cost	\$ 606	\$ 494	\$ 1,228	\$ 994
Interest cost	1,218	1,164	2,481	2,385
Expected return on plan assets	(1,203)	(1,211)	(2,449)	(2,484)
Amortization of prior service cost	37	37	74	74
Recognized actuarial loss	419	268	837	537
<b>Net periodic benefit cost</b>	<b>\$ 1,077</b>	<b>\$ 752</b>	<b>\$ 2,171</b>	<b>\$ 1,506</b>
<b>Post-Retirement Benefit Plans</b>				
Interest cost	\$ 79	\$ 91	\$ 158	\$ 182
Amortization of transition amount	18	123	36	246
Amortization of prior service cost	1	1	2	2
Recognized actuarial (gain) loss	16	(8)	32	(16)
<b>Net periodic benefit cost</b>	<b>\$ 114</b>	<b>\$ 207</b>	<b>\$ 228</b>	<b>\$ 414</b>

The Company made contributions to the defined benefit plans of \$3.2 million during the six months ended April 2, 2010. The Company currently expects total contributions to the defined benefit plans for fiscal year 2010 will be approximately \$5.9 million. The Company made contributions to the post-retirement benefit plans of \$0.3 million during the six months ended April 2, 2010. The Company currently expects total contributions to the post-retirement benefit plans for fiscal year 2010 will be approximately \$0.5 million.

Because amounts related to retirement plans of Research Instruments, which is classified as a discontinued operation, were not material for any period presented, the Company has not segregated them from continuing operations in this note. See Note 16, Discontinued Operations.

**11. INCOME TAXES**

The Company's effective tax rate was 32.6% for the three months ended April 2, 2010, compared to 34.9% in the same period of fiscal year 2009. The decrease in the Company's effective tax rate was primarily due to a shift in the geographic mix of earnings. For the six months ended April 2, 2010, the Company's effective tax rate was 33.1%, compared to 32.9% in the same period of fiscal year 2009. The slight increase was primarily due to a greater benefit from discrete items in the earlier period. For example, the earlier period included the benefit of the retroactive reinstatement of the federal research and development credit.

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 Company's unrecognized tax benefits decreased by \$13.9 million during the six-month period ended April 2, 2010, primarily because the Internal Revenue Service has consented to a tax accounting method change that the Company requested, and the statutes of limitation and audit

settlements expired in various jurisdictions. The decrease is partially offset by the positions taken during the current and prior years.

**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)****12. STOCKHOLDERS' EQUITY*****Stock Repurchase Program***

On November 17, 2008, VMS's Board of Directors authorized the repurchase of 8,000,000 shares of VMS common stock from January 1, 2009 through December 31, 2009. On November 13, 2009, the Company's Board of Directors authorized the repurchase of an additional 5,000,000 shares of VMS common stock from January 1, 2010 through December 31, 2010. During the six months ended April 2, 2010, the Company paid \$126.7 million to repurchase 2,700,000 shares of VMS common stock, of which \$71.6 million was paid during the three months ended April 2, 2010 to repurchase 1,450,000 shares. All shares that have been repurchased have been retired. The November 17, 2008 authorization expired on December 31, 2009 with 6,050,000 shares available for repurchase. As of April 2, 2010, the Company could repurchase up to an additional 3,550,000 shares of VMS common stock under the November 13, 2009 authorization.

***Comprehensive Earnings***

The components of comprehensive earnings are as follows:

(In thousands)	Three Months Ended		Six Months Ended	
	April 2, 2010	April 3, 2009	April 2, 2010	April 3, 2009
<b>Net earnings</b>	<b>\$ 91,114</b>	<b>\$ 67,813</b>	<b>\$ 169,889</b>	<b>\$ 136,610</b>
Other comprehensive income, net of tax:				
Defined benefit pension and post-retirement benefit plans:				
Amortization of transition obligation included in net periodic benefit cost	11	75	22	151
Amortization of prior service cost included in net periodic benefit cost	33	33	66	66
Amortization of net actuarial loss included in net periodic benefit cost	331	189	662	378
	375	297	750	595
Unrealized gain on derivatives:				
Increase in unrealized gain	396	2,914	1,112	5,207
Reclassification adjustments	(406)	(1,367)	(420)	(2,088)
	(10)	1,547	692	3,119
Currency translation adjustment	(5,411)	(3,109)	(7,077)	(4,991)
Reclassification of foreign currency translation resulting from the sale of Research Instruments		(778)		(778)
	(5,411)	(3,887)	(7,077)	(5,769)
<b>Other comprehensive income (loss)</b>	<b>(5,046)</b>	<b>(2,043)</b>	<b>(5,635)</b>	<b>(2,055)</b>
<b>Total comprehensive earnings</b>	<b>\$ 86,068</b>	<b>\$ 65,770</b>	<b>\$ 164,254</b>	<b>\$ 134,555</b>

Because amounts related to Research Instruments, which is classified as a discontinued operation, were not material for any period presented, the Company has not segregated them from continuing operations in this note. See Note 16 Discontinued Operations for a detailed discussion.



**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)****13. EMPLOYEE STOCK PLANS**

In February 2010, VMS's stockholders approved an amendment to the Second Amended and Restated 2005 Omnibus Stock Plan (the Second Amended 2005 Plan) to increase the number of shares available for grant under the plan by 5,500,000 shares.

The table below summarizes the share-based compensation expense under ASC 718:

(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	April 2, 2010	April 3, 2009	April 2, 2010	April 3, 2009
Cost of revenues - Product	\$ 715	\$ 1,050	\$ 1,606	\$ 2,126
Cost of revenues - Service contracts and other	513	1,008	1,172	2,049
Research and development	845	1,314	1,916	2,563
Selling, general and administrative	5,328	7,242	11,552	14,582
Taxes on earnings	(2,644)	(3,286)	(5,777)	(6,750)
Net decrease in net earnings	\$ 4,757	\$ 7,328	\$ 10,469	\$ 14,570
Increase (decrease) on:				
Cash flows from operating activities (1)	\$ (4,036)	\$ (3,026)	\$ (5,466)	\$ (6,022)
Cash flows from financing activities (1)	\$ 4,036	\$ 3,026	\$ 5,466	\$ 6,022

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

During the three and six months ended April 2, 2010, total share-based compensation expense recognized in earnings before taxes was \$7.4 million and \$16.2 million, respectively, and the total related recognized tax benefit was \$2.6 million and \$5.8 million, respectively. During the three and six months ended April 3, 2009, total share-based compensation expense recognized in earnings before taxes was \$10.6 million and \$21.3 million, respectively, and the total related recognized tax benefit was \$3.3 million and \$6.8 million, respectively. Total share-based compensation expense capitalized as part of inventory for the three and six months ended April 2, 2010 was \$62,000 and \$0.2 million, respectively. Total share-based compensation expense capitalized as part of inventory for the three and six months ended April 3, 2009 was \$0.4 million and \$0.8 million, respectively.

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

Employee Stock Option Plans	Three Months Ended		Six Months Ended	
	April 2, 2010	April 3, 2009	April 2, 2010	April 3, 2009
Expected term (in years)	4.42	4.57	4.42	4.57
Risk-free interest rate	2.1%	1.8%	2.1%	1.8%
Expected volatility	36.2%	39.2%	36.5%	39.2%
Expected dividend				



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Weighted average fair value at grant date	\$ 15.66	\$ 13.00	\$ 15.57	\$ 13.00
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In February 2010, VMS's stockholders approved the 2010 Employee Stock Purchase Plan (the 2010 ESPP), which provides eligible employees with an opportunity to purchase shares of VMS common stock at 85% of the lower of its fair market value at the start and end of each purchase period. Under VMS's practice, purchase periods have been comprised of two consecutive six-month periods ending at the end of VMS's second and fourth fiscal quarters. The 2010 ESPP provides for the purchase of up to 7 million shares of VMS common stock (including shares available for purchase under the prior Employee Stock Purchase Plan (the Prior ESPP) as of February 11, 2010, the date the 2010 ESPP became effective). In May 2009, as part of a broader set of cost control initiatives, VMS's Board of Directors authorized the suspension of purchases under the Prior ESPP beginning in October 2009. Once the 2010 ESPP became effective, purchases could no longer be made under the Prior ESPP. No purchases have yet been made under the 2010 ESPP.

**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)**

The option component of the Prior ESPP shares for the three and six months ended April 3, 2009 was estimated at the date of grant using the Black-Scholes model with the following weighted average assumptions:

	Three Months Ended April 2, 2010	April 3, 2009	Six Months Ended April 2, 2010	April 3, 2009
<b>Employee Stock Purchase Plan</b>				
Expected term (in years)		0.50		0.50
Risk-free interest rate		0.4%		0.4%
Expected volatility		54.1%		52.1%
Expected dividend				
Weighted average fair value at grant date		\$ 9.00		\$ 10.63

Activity under the Company's employee stock plans is presented below:

(In thousands, except per share amounts)	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Options Outstanding Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (3)
Balance at October 2, 2009	5,352	11,853	\$ 40.59		
Authorized	5,500				
Granted <sup>(1)</sup>	(82)	45	47.05		
Cancelled or expired <sup>(2)</sup>	182	(125)	51.26		
Exercised		(1,009)	28.12		
Balance at April 2, 2010	10,952	10,764	\$ 41.66	4.8	\$ 158,743
Exercisable at April 2, 2010		9,740	\$ 41.58	4.7	\$ 144,436

- (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 award of deferred stock units. Awards other than stock options were counted against the shares available for grant limit as three shares for every one share awarded before February 16, 2007 and as 2.5 shares for every one awarded on February 16, 2007 and thereafter.
- (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 (a) the cancellation of shares of restricted common stock and restricted stock units due to employee terminations and (b) the cancellation of shares of restricted common stock and restricted stock units that were tendered to VMS to satisfy employee tax withholding obligations at vesting of restricted common stock.
- (3) The aggregate intrinsic value represents the total pre-tax intrinsic value, which is computed based on the difference between the exercise price and VMS's closing common stock price of \$56.38 as of April 1, 2010, the last trading date of the second quarter of fiscal year 2010, and which would have been received by the option holders had all option holders exercised and sold their options as of that date.



**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)**

As of April 2, 2010, there was \$8.2 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 1.5 years.

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

(In thousands, except per share amounts)	Shares	Weighted Average Grant- Date Fair Value
Balance at October 2, 2009	1,172	\$ 42.89
Granted	15	47.58
Vested	(403)	44.72
Cancelled or expired	(13)	43.21
Balance at April 2, 2010	771	\$ 42.02

As of April 2, 2010, unrecognized compensation expense totaling \$28.1 million was related to restricted stock, restricted stock units and deferred stock units. This unrecognized compensation expense is expected to be recognized over a weighted average period of 2.0 years.

Because amounts related to employee stock plans of Research Instruments, which is classified as a discontinued operation, were not material for any period presented, the Company has not segregated them from continuing operations in this note. See Note 16, Discontinued Operations.

**14. EARNINGS PER SHARE**

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

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

(In thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	April 2, 2010	April 3, 2009	April 2, 2010	April 3, 2009
Earnings from continuing operations	\$ 91,114	\$ 79,358	\$ 169,889	\$ 148,937
Loss from discontinued operations, net of taxes		(11,545)		(12,327)
Net earnings	\$ 91,114	\$ 67,813	\$ 169,889	\$ 136,610
Basic weighted average shares outstanding	122,938	123,782	123,313	123,836
Dilutive effect of potential common shares	1,399	715	1,191	1,000
Diluted weighted average shares outstanding	124,337	124,497	124,504	124,836

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Net earnings (loss) per share - basic:								
Continuing operations	\$	0.74	\$	0.64	\$	1.38	\$	1.20
Discontinued operations				(0.09)				(0.10)
Net earnings per share	\$	0.74	\$	0.55	\$	1.38	\$	1.10
Net earnings (loss) per share - diluted:								
Continuing operations	\$	0.73	\$	0.64	\$	1.36	\$	1.19
Discontinued operations				(0.10)				(0.10)
Net earnings per share	\$	0.73	\$	0.54	\$	1.36	\$	1.09

**Table of Contents****VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(Unaudited)**

The Company excludes shares underlying stock options from the computation of diluted weighted average shares outstanding if the per share value, including the sum of (a) the exercise price of the options and (b) the amount of the compensation cost attributed to future services and not yet recognized, is greater than the average market price of the shares, because the inclusion of the shares underlying these stock options would be antidilutive to earnings per share. Accordingly, stock options to purchase 3,326,616 shares and 8,405,517 shares at average exercise prices of \$51.53 and \$46.75, respectively, per share were excluded from the computation of diluted weighted average shares outstanding for the three months ended April 2, 2010 and April 3, 2009, respectively. Stock options to purchase 5,271,706 shares and 8,333,979 shares at average exercise prices of \$50.90 and \$46.84, respectively, per share were excluded from the computation of diluted weighted average shares outstanding for the six months ended April 2, 2010 and April 3, 2009, respectively.

**15. SEGMENT INFORMATION**

The Company's operations are grouped into two reportable operating segments: Oncology Systems and X-ray Products. These reportable operating segments were determined based on how the Company's Chief Executive Officer, its Chief Operating Decision Maker ( CODM ), views and evaluates the Company's operations. The Company's Ginzton Technology Center ( GTC ), SIP business and Varian Particle Therapy (previously known as ACCEL Proton Therapy) are reflected in the Other category because these operations 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:

(In millions)	Three Months Ended		Six Months Ended	
	April 2, 2010	April 3, 2009	April 2, 2010	April 3, 2009
<b>Revenues</b>				
Oncology Systems	\$ 465	\$ 445	\$ 895	\$ 843
X-ray Products	102	86	193	172
Total reportable segments	\$ 567	\$ 531	\$ 1,088	\$ 1,015
Other	18	22	38	47
Total company	\$ 585	\$ 553	\$ 1,126	\$ 1,062
<b>Operating Earnings (Loss)</b>				
Oncology Systems	\$ 120	\$ 118	\$ 222	\$ 216
X-ray Products	23	21	46	42
Total reportable segments	\$ 143	\$ 139	\$ 268	\$ 258
Other	(8)		(19)	
Corporate <sup>(1)</sup>	1	(17)	6	(37)
Total company	\$ 136	\$ 122	\$ 255	\$ 221

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- (1) Corporate includes shared costs of legal, tax, accounting, human resources, real estate, insurance, information technology, treasury, finance and other management costs. Prior to fiscal year 2010, only a portion of the indirect and common costs has been allocated through the use of estimates. Beginning in fiscal year 2010, budgeted indirect and common costs included in Corporate are fully allocated through the use of estimates. If the fiscal year 2010 corporate expense allocation method was applied in the three months ended April 3, 2009, operating earnings (loss) would have been \$102 million for Oncology Systems, \$18 million for X-ray Products, \$(1) million for the Other category and \$3 million for Corporate. If the fiscal year 2010 corporate expense allocation method was applied in the six months ended April 3, 2009, operating earnings (loss) would have been \$184 million for Oncology Systems, \$36 million for X-ray Products, \$(3) million for the Other category and \$4 million for Corporate.

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**VARIAN MEDICAL SYSTEMS, INC. AND SUBSIDIARIES**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**(Unaudited)**

**16. DISCONTINUED OPERATIONS**

In September 2008, the Company approved a plan to sell Research Instruments, which developed, manufactured and serviced highly customized scientific instrument components and systems for fundamental and applied physics research primarily for national research laboratories worldwide. Research Instruments was part of the January 2007 ACCEL acquisition and was previously included in the Other category in the Company's Condensed Consolidated Financial Statements. The Company decided to sell Research Instruments in order to focus exclusively on the development of its Varian Particle Therapy business. In the second quarter of fiscal year 2009, the Company completed the sale of Research Instruments for total cash proceeds of \$0.4 million. In connection with the sale of Research Instruments, the Company entered into a non-binding supply agreement with the buyer to supply certain inventory parts for the Varian Particle Therapy business. The supply agreement can be terminated by either party upon a six months' notice after December 31, 2011. The inventory purchases under this supply agreement are not expected to have a significant impact on the cash flows of Research Instruments.

The Company classified the operating results of Research Instruments as a discontinued operation in the Condensed Consolidated Statements of Earnings for all periods presented. Because the amounts related to Research Instruments are not material in the Condensed Consolidated Balance Sheet and the Condensed Consolidated Statements of Cash Flows for all periods presented, the Company has not segregated them from continuing operations.

Total revenues of Research Instruments, reported in discontinued operations, for the three and six months ended April 2, 2010, were \$0.1 million and \$0.2 million, respectively. Total revenues of Research Instruments, reported in discontinued operations, for the three and six months ended April 3, 2009 were \$4.8 million and \$9.0 million, respectively. Research Instruments did not have any profit or loss for the three and six months ended April 2, 2010. Including an \$8.1 million loss on disposal of Research Instruments, the losses reporting in discontinued operations for the three and six months ended April 3, 2009 were \$11.5 million and \$12.3 million, respectively.



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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and

Stockholders of Varian Medical Systems, Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Varian Medical Systems, Inc. and its subsidiaries (the Company) as of April 2, 2010 and the related condensed consolidated statements of earnings for the three-month and six-month periods ended April 2, 2010 and April 3, 2009 and the condensed consolidated statements of cash flows for the six-month period ended April 2, 2010 and April 3, 2009. 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 October 2, 2009, 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 25, 2009, we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of October 2, 2009, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ **PRICEWATERHOUSECOOPERS LLP**

San Jose, CA  
May 11, 2010

**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 ( VMAT ), stereotactic radiotherapy, stereotactic radiosurgery, brachytherapy, software, treatment techniques, proton therapy and advanced x-ray products; growth drivers; future orders, revenues, backlog, earnings or other financial results; and any statements using the terms believe, expect, anticipate, estimate, should, would, could, can, may, will, ongoing, likely, and possible or similar statements are forward-looking statements. In 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 second quarter of fiscal year 2010, revenues from continuing operations grew 6%, or 3% on a constant currency basis, from the year-ago quarter. Net orders in the second quarter of fiscal year 2010 grew 13%, or 10% on a constant currency basis, from the year-ago quarter. Continued strength in the international region drove revenue and net order growth in the second quarter of fiscal year 2010, which was partially offset by the declines in revenues and net orders in North America. Higher revenues from Oncology Systems and X-ray Products, ongoing cost control initiatives and a lower tax rate contributed to a 15% increase in net earnings, and a 14% increase in net earnings per diluted share, from continuing operations in the second quarter of fiscal year 2010 over the year-ago quarter.

Effective in the fourth quarter of fiscal year 2008, we classified the scientific research instruments business ( Research Instruments ) of ACCEL Instruments GmbH ( ACCEL ) (which subsequently changed its name to Varian Medical Systems Particle Therapy GmbH) as a discontinued operation. Research Instruments is classified as a discontinued operation for all periods presented in our Condensed Consolidated Statements of Earnings. Unless otherwise stated, the discussion in this MD&A pertains to our continuing operations.

**Oncology Systems.** Our largest business segment is Oncology Systems, which designs, manufactures, sells and services hardware and software products for radiation treatment of cancer with conventional radiotherapy, IMRT, IGRT, VMAT (an advanced form of IMRT), stereotactic radiotherapy, stereotactic radiosurgery and brachytherapy.

In our view, the fundamental market forces that should drive long-term growth in radiation therapy, stereotactic radiosurgery and brachytherapy are the rising cancer incidence; technology advances and product developments that are leading to improvements in patient care; customer demand for more advanced and effective cancer treatments, such as fixed field IMRT, IGRT, stereotactic radiosurgery, brachytherapy and VMAT; 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. Our primary goal in the Oncology Systems business is to promote the adoption of more advanced and effective cancer treatments.

The international region accounted for the growth in Oncology Systems net orders and revenues in the second quarter of fiscal year 2010 over the year-ago quarter which was partially offset by decreases in net orders and revenues for North America. Our international growth in net orders and revenues benefited, in part, from the weaker U.S. dollar against foreign currencies in the second quarter as compared to the year-ago quarter.

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North America continued to be adversely impacted by smaller capital budgets that were established in response to uncertainty created by the recession and healthcare reform in the United States. We are not able to determine if the recently enacted Affordable Health Care for America Act will accelerate our long-term growth or reduce the demand for our products and services. We believe that recovery of our business in North America may not occur until healthcare providers approve larger capital equipment expenditures as part of new, more normal budget cycles. Our business, historically, has felt the effects of market trends later than other sectors in the healthcare industry, such as diagnostic radiology, and we may experience the effects of any economic recovery later than others in the healthcare industry.

Overall, the U.S. dollar was weaker against foreign currencies in the first half of fiscal year 2010 than it was in the first half of fiscal year 2009, which made our pricing more competitive in the local currencies of our international customers and favorably impacted our net order and revenue growth in the international region when measured in U.S. dollars. However, the strengthening of the U.S. dollar against foreign currencies will negatively impact our international revenues and net orders when measured in U.S. dollars. Also, while the recent economic downturn has primarily affected our business in North America, potential future economic turmoil, such as the banking and currency instability in Greece and other countries, may negatively affect our international business.

In the second quarter of fiscal year 2010, we introduced the TrueBeam system for image-guided radiotherapy and radiosurgery. This product line is a fully-integrated system designed from the ground up to treat a moving target with higher speed and accuracy. We booked revenue on two TrueBeam systems during the second fiscal quarter and recorded more than 15 orders for these systems, including some backlog conversions. We believe TrueBeam will be a valuable tool for clinicians in the fight against cancer and we expect it will stimulate stronger demand for our surgical products, as well as faster replacement of older systems in our installed base. Also, in April 2010, we announced the addition of advanced motion management capabilities, including gated RapidArc<sup>®</sup>, to our Clinac<sup>®</sup> iX and Trilogy linear accelerators. Gated RapidArc radiotherapy makes it possible to monitor patient breathing and compensate for tumor motion while quickly delivering dose during a continuous rotation around the patient. Our ability to successfully introduce and commercialize new product lines, such as TrueBeam, without disrupting the ongoing demand for our existing product lines is important. Failure to do so may have a negative impact on revenues and net earnings.

**X-ray Products.** Our X-ray Products business segment designs, manufactures and sells: (i) x-ray tubes for use in a range of applications, including computed tomography ( CT ) scanning, radiographic or fluoroscopic imaging, mammography, special procedures and industrial applications; and (ii) flat panel digital image detectors for filmless x-ray imaging, which is for radiography an alternative to image intensifier tubes for fluoroscopy and x-ray film and computed radiography ( CR ) systems. 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.

For the second quarter of fiscal year 2010, X-ray Products saw double-digit growth in revenues and net orders in both North America and the international region over the year-ago quarter. Both the flat panel and the x-ray tube product lines contributed to net order growth in the second quarter of fiscal year 2010 over the year-ago quarter. For the second quarter of fiscal year 2010, the increase in revenues from sales of flat panel products was partially offset by the decrease in revenues from sales of x-ray tube products. We believe we are seeing early signs of a recovery in the global imaging equipment industry.

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. Also, any effect on reimbursement for or access to diagnostic radiology as a result of the Affordable Health Care for America Act and related state proposals will likely affect demand for our products.

**Other.** The Other category is comprised of Security and Inspections Products ( SIP ), the Varian Particle Therapy business, and the operations of the Gintzon Technology Center ( GTC ). (Please refer to Note 15, Segment Information to the Condensed Consolidated Financial Statements within this Quarterly Report on Form 10-Q.)

SIP designs, manufactures, sells and services Linatron<sup>®</sup> x-ray accelerators, imaging processing software and image detection products (including IntellX) for security and inspection. Generally, we sell our SIP products to OEMs who incorporate them into their inspection systems. Use of this technology in security cargo screening and border protection is still in its early stages but we believe growth will be driven by cargo screening and border protection needs and the needs of customs agencies to verify the shipment contents for assessing duties and taxes. This business is heavily influenced by governmental policies on national and homeland security, political change, and government budgets and appropriations. Orders and revenues for our SIP products have been and may continue to be unpredictable as governmental agencies may place large orders in a short time period, and then may not place any orders for a long time period thereafter.

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Our Varian Particle Therapy business designs, develops, manufactures and services products and systems for delivering proton therapy, another form of external beam radiotherapy using proton beams for the treatment of cancer. Proton therapy is considered as a preferred option for treating certain kinds of cancers, particularly tumors near critical structures such as the optic nerve and cancers in children. Although proton therapy has been in clinical use for more than four decades, it has not been widely deployed due to the cost of the technology and higher cost per patient. Proton therapy facilities are large scale construction projects that are time consuming and involve significant customer investment and perhaps complex project financing. Consequently, this business is vulnerable to the general worldwide economic downturn and contraction in the credit markets. In addition, the customer's decision-making cycle is very long and orders for proton therapy systems generally involve many contingencies. We are investing substantial resources to commercialize this advanced proton technology and to build this new business. We currently have one proton therapy system being commissioned at a customer facility in Munich, Germany and, as of the end of the second quarter of fiscal year 2010, three of the four treatment gantries at the facility were treating patients.

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

In the second quarter of fiscal year 2010, net orders and revenues in the Other category declined from the year-ago quarter primarily due to the net order and revenue declines in SIP products. Net orders in the Other category were negative \$28 million in the first half of fiscal year 2010 primarily due to the cancellation of a \$62 million proton therapy system order from Skandion Kliniken in the first quarter of fiscal year 2010, which is discussed in more detail in this MD&A under 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, as well as the Consolidated Financial Statements and the Notes to the Consolidated Financial Statements and the related Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended October 2, 2009 (the 2009 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 2009 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, also refer to the Risk Factors listed under Part II, Item 1A of this Quarterly Report on Form 10-Q.

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### ***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.

At the beginning of its second quarter of fiscal year 2010, we elected to early adopt the amended software revenue guidance and amended multiple deliverable revenue arrangement guidance on a prospective basis as of the beginning of fiscal year 2010 and has applied the amended guidance for revenue arrangements originating or materially modified after October 2, 2009. Under the amended guidance, 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 is considered as non-software products for purpose of revenue recognition. The allocation of consideration to each non-software deliverable is based on our assumptions used 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 or 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.

Under the prior authoritative guidance, the allocation of consideration to each deliverable in a multiple deliverable arrangement is affected by our judgment as to whether objective and reliable evidence of fair value exists for hardware deliverables and VSOE of the fair value exists for software deliverables 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.

In addition, revenues related to our highly customized image detection systems are recognized under the percentage-of-completion method. Under the percentage-of-completion method of accounting, sales and gross profit are recognized as work is performed, based on the relationship between actual costs incurred and total estimated costs at the completion of the contract. 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 periods. If a loss is expected on a contract under the percentage-of-completion method or completed contract method, the estimated loss would be charged to cost of sales in the period the loss is identified.

### ***Share-based Compensation Expense***

We value our share-based payment awards granted using the Black-Scholes option-pricing model. The determination of fair value of share-based payment awards on the date of grant using the Black-Scholes option-pricing model is affected by VMS's stock price, as well as the input of other subjective assumptions, including the expected term of stock awards and the expected price volatility of VMS stock over the expected term of the awards.

The expected term is based on the observed and expected time to post-vesting exercise and post-vesting cancellations of stock options by our employees. We determined the expected term of stock options based on the demographic grouping of employees and retirement eligibility. We used a combination of historical and implied volatility, or blended volatility, in deriving the expected volatility assumption. Blended volatility represents the weighted average of implied volatility and historical volatility. Implied volatility was derived based on six-month traded options on VMS common stock. Implied volatility is weighted in the calculation of blended volatility based on the ratio of the six-month term of the exchange-traded options to the expected lives of the employee stock options. Historical volatility represents the remainder of the weighting. Our decision to incorporate implied volatility was based on our assessment that implied volatility of publicly traded options on VMS common stock is reflective of market conditions and is generally reflective of both historical volatility and expectations of how future volatility will differ from historical volatility. In determining the extent of use of implied volatility, we considered: (i) the volume of market activity of traded options; (ii) the ability to reasonably match the input variables of traded options to those of stock options granted by us, including the date of grant; (iii) the similarity of the

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exercise prices; and (iv) the length of term of traded options. After considering the above factors, we determined that we could not rely exclusively on implied volatility based on the fact that the term of VMS six-month exchange-traded options is less than one year and that it is different from the expected lives of the stock options we grant. Therefore, we believe a combination of the historical volatility over the expected lives of the stock options we granted and the implied volatility of six-month exchange-traded options best reflects the expected volatility of VMS common stock. The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of our stock options. The dividend yield assumption is based on our history and expectation of no dividend payouts. If factors change and we employ different assumptions in future periods, the compensation expense that we record may differ significantly from what we have recorded in the current period. In addition, we are required to estimate the expected forfeiture rate and recognize expense only for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period.

***Allowance for Doubtful Accounts***

We evaluate the creditworthiness of our customers prior to authorizing shipment for all major sale transactions. Except in our X-ray Products business, our payment terms usually require payment of a small portion of the total amount due when the customer signs the purchase order, a significant amount upon transfer of risk of loss to the customer and the remaining amount upon completion of the installation. On a quarterly basis, we evaluate aged items in the accounts receivable aging report and provide an allowance in an amount we deem adequate for doubtful accounts. If our evaluation of our customers' financial conditions does not reflect our future ability to collect outstanding receivables, additional provisions may be needed and our operating results could be negatively affected.

***Inventories***

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

***Goodwill and Intangible Assets***

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

In accordance with Accounting Standard Codification (ASC 350), we evaluate goodwill for impairment at least annually or whenever an event occurs or circumstances changes that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The impairment test for goodwill is a two-step process. Step one consists of a comparison of the fair value of a reporting unit against its carrying amount, including the goodwill allocated to each reporting unit. We determine the fair value of our reporting units based on the present value of estimated future cash flows of the reporting units. If the carrying amount of the reporting unit is in excess of its fair value, step two requires the comparison of the implied fair value of the reporting unit's goodwill against the carrying amount of the reporting unit's goodwill. Any excess of the carrying value of the reporting unit's goodwill over the implied fair value of the reporting unit's goodwill is recorded as an impairment loss. The impairment test for intangible assets with indefinite useful lives, if any, consists of a comparison of fair value to carrying value, with any excess of carrying value over fair value being recorded as an impairment loss. Based on the most recent annual goodwill impairment testing that we performed in the fourth quarter of fiscal year 2009 for each of our four reporting units with goodwill (Oncology Systems, X-ray Products, SIP and Varian Particle Therapy), the fair value of each such reporting unit was substantially in excess of its carrying value. We will continue to make assessments of impairment on an annual basis in the fourth quarter of our fiscal years or more frequently if indicators of potential impairment arise.



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**Table of Contents*****Warranty Obligations***

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

***Environmental Matters***

We are subject to a variety of environmental laws around the world. Those laws regulate multiple aspects of our operations, including the handling, storage, transport and disposal of hazardous substances. They impose costs on our operations and in connection with past operations. In connection with past operations, we record environmental remediation liabilities when we conclude that environmental assessments or remediation efforts are probable and we believe we can reasonably estimate the costs of those efforts. Our accrued environmental costs represent our best estimate of the total costs of assessments and remediation and the time period over which we expect to incur those costs. We review these accrued balances quarterly. Were we required to increase or decrease the accrued environmental costs in the future, it would adversely or favorably impact our operating results.

***Defined Benefit Pension and Post-Retirement Benefit Plans***

We sponsor five defined benefit pension plans in Germany, Japan, Switzerland and the United Kingdom covering employees who meet the applicable eligibility requirements in these countries. In July 2007, we made changes to the defined benefit pension plan in the United Kingdom by terminating the accrual of additional benefits for existing participants and suspending the enrollment of new participants. We also sponsor a post-retirement benefit plan that provides healthcare benefits to certain eligible retirees in the United States. We do not have any defined benefit pension plans in the United States. Several statistical and other factors that attempt to anticipate future events are used in calculating the expense and liability related to those plans for which the benefit is actuarially determined, such as our defined benefit pension and post-retirement benefit plans. These factors include assumptions about the discount rate, expected return on plan assets, rate of future compensation increases and rate of healthcare cost increases, all of which we determine within certain guidelines. In addition, we also use assumptions, such as withdrawal and mortality rates, to calculate the expense and liability. The actuarial assumptions we use are long-term assumptions and may differ materially from actual experience particularly in the short term due to changing market and economic conditions and changing participant demographics. These differences may have a significant impact on the amount of defined benefit pension and post-retirement benefit plan expense we record.

The expected rates of return on the various defined benefit pension plans' assets are based on the asset allocation of each plan and the long-term projected return on those assets. The discount rate enables us to state expected future cash flows at a present value on the measurement date. The discount rates used for defined benefit plans in all countries are based primarily on the yields of a universe of high quality corporate bonds in each country or the spot rate of high quality AA-rated corporate bonds, with durations corresponding to the expected durations of the benefit obligations. In countries where the corporate bond market is not sufficiently representative of the time period at longer durations, the discount rate also takes into account the yield of long-term government bonds corresponding to the duration of the benefit obligations and the difference between the yield curve on high quality corporate fixed-income investments and government fixed-income investment. A change in the discount rate will cause the present value of benefit obligations to change in the opposite direction.

***Valuation of Derivative Instruments***

We use foreign currency forward contracts to reduce the effects of currency fluctuations on sales transactions denominated in foreign currencies and on assets and liabilities denominated in foreign currencies. These foreign currency forward contracts are derivative instruments and are measured at fair value. ASC 820 establishes three levels of inputs that may be used to measure fair value (see Note 3, Fair Value Measurements to Condensed Consolidated Financial Statements). Each level of input has different levels of subjectivity and difficulty involved in determining fair value. The fair value of foreign currency



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forward contracts are calculated primarily using Level 2 inputs, which include currency spot and forward rates, interest rate and credit or non-performance risk. The spot rate for each currency is the same spot rate used for all balance sheet translations at the measurement date and sourced from our major trading banks. The following values are interpolated from commonly quoted broker services: forward point values for each currency and the London Interbank Offered Rate ( LIBOR ) to discount assets and liabilities. One year credit default swap spreads of the counterparty at the measurement date are used to adjust derivative assets, all of which have maturity terms of less than 12 months, for non-performance risk. We are required to adjust derivative liabilities to reflect the potential non-performance risk to lenders based on our incremental borrowing rate. Each contract is individually adjusted using the counterparty (for net asset) or our discount rate (for net liability). The use of Level 2 inputs in determining fair values requires certain management judgment and subjectivity. Changes to these Level 2 inputs could have a material impact to the valuation of our derivative instruments, as well as on our result of operations.

### ***Taxes on Earnings***

We are subject to taxes on earnings in both the United States and numerous foreign jurisdictions. As a global taxpayer, significant judgments and estimates are required in evaluating our tax positions and determining our provision for taxes on earnings.

The provisions in ASC 740 related to accounting for uncertainty in income taxes contain a two-step approach to recognizing, derecognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining whether the weight of available evidence indicates that it is more likely than not that, based on the technical merits, the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon settlement. Recognition, derecognition and measurement are based on management's best judgment given the facts, circumstances and information available at the end of the accounting period. A tax benefit should be recognized in the first period in which it meets the more likely than not recognition threshold, and conversely, a tax benefit previously recognized should be derecognized in the first period in which new information results in a change in judgment in which the position fails to meet the recognition threshold. A benefit not previously recognized would be recognized when the tax position is effectively settled through examination, negotiation or litigation with tax authorities, or when the statute of limitations for the relevant taxing authority to examine and challenge the position has expired. Our policy is to include interest and penalties related to unrecognized tax benefits within the provision for taxes on earnings.

In addition, the carrying value of our net deferred tax assets assumes that we will be able to generate sufficient future taxable earnings in certain tax jurisdictions to utilize these deferred tax assets. Should we conclude it is more likely than not that we will be unable to recover our net deferred tax assets in these tax jurisdictions, we would increase our valuation allowance and our tax provision would increase in the period in which we make such a determination.

Earnings derived from our international regions are generally taxed at rates lower than U.S. rates. Our effective tax rate is impacted by existing tax laws in both the United States and in the respective countries in which our international subsidiaries do business. In addition, a decrease in the percentage of our total earnings from our international regions, or a change in the mix of international regions among particular tax jurisdictions, could increase our effective tax rate. Also, our current effective tax rate does not assume U.S. taxes on certain undistributed profits of certain foreign subsidiaries. These earnings could become subject to incremental foreign withholding or U.S. federal and state taxes should they either be deemed or actually remitted to the United States.

### **Results of Operations**

#### ***Fiscal Year***

Our fiscal year is the 52- or 53-week period ending on the Friday nearest September 30. Fiscal year 2010 is the 52-week period ending October 1, 2010, and fiscal year 2009 was the 53-week period ended on October 2, 2009. The fiscal quarters ended April 2, 2010 and April 3, 2009 were both 13-week periods.

**Table of Contents****Discussion of Financial Data for the Second Quarter and First Six Months of Fiscal Year 2010 Compared to the Second Quarter and First Six Months of Fiscal Year 2009****Total Revenues**

Revenues by sales classification (Dollars in millions)	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
Product	\$ 454.4	\$ 449.3	1%	\$ 864.6	\$ 851.5	2%
Service Contracts and Other	131.2	104.3	26%	261.9	210.8	24%
<b>Total Revenues</b>	<b>\$ 585.6</b>	<b>\$ 553.6</b>	<b>6%</b>	<b>\$ 1,126.5</b>	<b>\$ 1,062.3</b>	<b>6%</b>
<i>Product as a percentage of total revenues</i>	78%	81%		77%	80%	
<i>Service Contracts and Other as a percentage of total revenues</i>	22%	19%		23%	20%	
<b>Revenues by region</b>						
North America	\$ 255.0	\$ 277.3	(8%)	\$ 482.8	\$ 553.1	(13%)
Europe	169.3	145.7	16%	362.3	276.5	31%
Asia	139.3	116.6	19%	243.5	204.7	19%
Rest of world	22.0	14.0	57%	37.9	28.0	35%
<b>Total International (1)</b>	<b>330.6</b>	<b>276.3</b>	<b>20%</b>	<b>643.7</b>	<b>509.2</b>	<b>26%</b>
<b>Total</b>	<b>\$ 585.6</b>	<b>\$ 553.6</b>	<b>6%</b>	<b>\$ 1,126.5</b>	<b>\$ 1,062.3</b>	<b>6%</b>
<i>North America as a percentage of total revenues</i>	44%	50%		43%	52%	
<i>International as a percentage of total revenues</i>	56%	50%		57%	48%	

(1) We consider international revenues to be revenues outside of North America.

Increased revenues in the second quarter and the first half of fiscal year 2010 over the respective year-ago periods was due to revenue growth in Oncology Systems, X-ray Products and, to a lesser extent, Varian Particle Therapy, partially offset by a decline in SIP revenues. For the second quarter of fiscal year 2010, X-ray Products contributed to the growth in product revenues while Oncology Systems and SIP product revenues decreased. For the first half of fiscal year 2010, Oncology Systems and X-ray Products contributed to the growth in product revenues while SIP product revenues decreased. The increase in service contracts and other revenues in the second quarter and first half of 2010 was primarily driven by the increase in Oncology Systems service contract revenues and, to a lesser extent, an increase in Varian Particle Therapy service revenues.

North American revenues decreased in the second quarter and the first half of fiscal year 2010 over the respective year-ago periods primarily due to a decrease in Oncology Systems North American revenues and, to a lesser extent, decreases in SIP North American revenues, partially offset by an increase in X-ray Products North American revenues.

International revenues increased in the second quarter of fiscal year 2010 over the year-ago quarter, primarily due to increases in international revenues in Oncology Systems and X-ray Products and, to a lesser extent, Varian Particle Therapy. International revenues increased in the first half of fiscal year 2010 over the year-ago period, primarily due to increases in international revenues in Oncology Systems and X-ray Products and, to a lesser extent, Varian Particle Therapy, partially offset by a decline in SIP international revenues. The weaker U.S. dollar against foreign currencies in the second quarter and the first half of fiscal year 2010 compared to the respective year-ago periods favorably affected our international revenues when measured in U.S. dollars.



**Table of Contents****Oncology Systems Revenues**

Revenues by sales classification (Dollars in millions)	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
Product	\$ 339.6	\$ 343.1	(1%)	\$ 646.0	\$ 637.7	1%
Service Contracts (1)	124.9	101.5	23%	248.6	205.1	21%
<b>Total Oncology Systems revenues</b>	<b>\$ 464.5</b>	<b>\$ 444.6</b>	<b>4%</b>	<b>\$ 894.6</b>	<b>\$ 842.8</b>	<b>6%</b>
<i>Product as a percentage of total Oncology Systems revenues</i>	<i>73%</i>	<i>77%</i>		<i>72%</i>	<i>76%</i>	
<i>Service Contracts as a percentage of Oncology Systems revenues</i>	<i>27%</i>	<i>23%</i>		<i>28%</i>	<i>24%</i>	
<i>Oncology Systems revenues as a percentage of total revenues</i>	<i>79%</i>	<i>80%</i>		<i>79%</i>	<i>79%</i>	

(1) Revenues from service contracts represent revenues from fixed-term service contracts and labor cost services. This excludes revenues from spare parts sold by our service department.

For the second quarter and the first half of fiscal year 2010, increases in product revenues over the respective year-ago periods from sales of our software products were offset by decreases in product revenues from sales of our linear accelerators, particularly in North America. The increases in service contract revenues in the second quarter and the first half of fiscal year 2010 over the respective year-ago periods were primarily driven by increased customer adoption of service contracts, as the sophistication of our products and the installed base of our products continue to increase. In addition, the weaker U.S. dollar against foreign currencies in the second quarter and the first half of fiscal year 2010 compared to the respective year-ago periods also favorably affected our international revenues when measured in U.S. dollars.

Revenues by region (Dollars in millions)	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
North America	\$ 216.0	\$ 235.4	(8%)	\$ 412.7	\$ 474.5	(13%)
Europe	142.9	122.1	17%	305.5	226.5	35%
Asia	84.7	75.1	13%	140.8	118.1	19%
Rest of world	20.9	12.0	74%	35.6	23.7	51%
<b>Total International</b>	<b>248.5</b>	<b>209.2</b>	<b>19%</b>	<b>481.9</b>	<b>368.3</b>	<b>31%</b>
<b>Total Oncology Systems Revenues</b>	<b>\$ 464.5</b>	<b>\$ 444.6</b>	<b>4%</b>	<b>\$ 894.6</b>	<b>\$ 842.8</b>	<b>6%</b>
<i>North America as a percentage of Oncology Systems revenues</i>	<i>47%</i>	<i>53%</i>		<i>46%</i>	<i>56%</i>	
<i>International as a percentage of Oncology Systems revenues</i>	<i>53%</i>	<i>47%</i>		<i>54%</i>	<i>44%</i>	

The international region drove the growth in Oncology Systems revenues in the second quarter and the first half of fiscal year 2010 over the respective year-ago periods, representing more than half of total Oncology Systems revenues for each of those periods. For the second quarter and the first half of fiscal year 2010, international revenues from sales of most of Oncology Systems product lines, as well as service contracts, increased over the respective year-ago periods. The weaker U.S. dollar against foreign currencies in the second quarter and the first half of fiscal year 2010 compared to the respective year-ago periods also favorably affected our international revenues when measured in U.S. dollars.

In the second quarter and first half of fiscal year 2010, North American revenues declined compared to the respective year-ago periods. North American revenues from sales of most of Oncology Systems product lines decreased in the second quarter and the first half of fiscal year 2010

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over the respective year-ago periods, although the decrease was partially offset by increased service contract revenues in the second quarter and the first half of fiscal year 2010.

Varying cycles of higher and lower revenues between the international and North American regions is a historical pattern reflecting regional influences such as effects of the recession, uncertainty created by healthcare reform and reductions in Medicare reimbursement rates for radiotherapy and radiosurgery in the United States and different technology adoption cycles that are consistent with the net order patterns discussed more fully under Net Orders.

**Table of Contents*****X-ray Products Revenues***

Revenues by region (Dollars in millions)	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
North America	\$ 34.1	\$ 30.0	14%	\$ 61.7	\$ 58.9	5%
Europe	14.4	13.4	7%	29.4	24.8	18%
Asia	52.6	40.4	30%	100.2	83.8	20%
Rest of world	1.1	2.0	(45%)	2.3	4.4	(47%)
Total International	68.1	55.8	22%	131.9	113.0	17%
Total X-ray Products Revenues	\$ 102.2	\$ 85.8	19%	\$ 193.6	\$ 171.9	13%
<i>North America as a percentage of X-ray Products revenues</i>	<i>33%</i>	<i>35%</i>		<i>32%</i>	<i>34%</i>	
<i>International as a percentage of X-ray Products revenues</i>	<i>67%</i>	<i>65%</i>		<i>68%</i>	<i>66%</i>	
<i>X-ray Products revenues as a percentage of total revenues</i>	<i>17%</i>	<i>16%</i>		<i>17%</i>	<i>16%</i>	

Both the international and North American regions contributed to the growth in X-ray Products revenues in the second quarter and the first half of fiscal year 2010 over the respective year-ago periods.

The increases in international revenues in the second quarter and the first half of fiscal year 2010 over the respective year-ago periods were primarily due to increased revenues from sales of our flat panel products, including our radiographic flat panels, in Europe and Asia, and from sales of our x-ray tube products in Asia. These increases were partially offset by decreased revenues from sales of our x-ray tubes in Europe and the rest of the world region. In North America, the increases in revenues for the second quarter and the first half of fiscal year 2010 over the respective year ago periods were due to increases in revenues from sales of our flat panel products, including our radiographic flat panels, partially offset by decreases in sales of our x-ray tube products.

***Other Revenues***

Revenues by sales classification (Dollars in millions)	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
Product	\$ 12.6	\$ 20.5	(38%)	\$ 25.0	\$ 41.9	(40%)
Service Contracts	6.3	2.7	127%	13.3	5.7	132%
Total Other revenues	\$ 18.9	\$ 23.2	(19%)	\$ 38.3	\$ 47.6	(19%)

*Other revenues as a percentage of total revenues* 4% 4% 4% 5%

Revenues in our Other category, which is comprised of SIP, Varian Particle Therapy and GTC, decreased in the second quarter and the first half of fiscal year 2010 over the respective year-ago periods primarily due to a decline in SIP product revenues as a result of lower revenues associated with customer acceptance and customer requested delays in product deliveries, partially offset by higher service revenues from Varian Particle Therapy related to the commissioning of a proton therapy system.

**Table of Contents****Gross Margin**

(Dollars in millions)	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
<b>Dollar by segment</b>						
Oncology Systems	\$ 209.7	\$ 195.7	7%	\$ 409.9	\$ 369.5	11%
X-ray Products	39.3	34.7	13%	76.9	69.4	11%
Other	5.0	10.0	(50%)	8.2	20.5	(60%)
Gross margin	\$ 254.0	\$ 240.4	6%	\$ 495.0	\$ 459.4	8%

**Percentage by segment**

<i>Oncology Systems</i>	45.2%	44.0%	45.8%	43.9%
<i>X-ray Products</i>	38.5%	40.5%	39.8%	40.4%
<i>Total Company</i>	43.4%	43.4%	43.9%	43.2%

For the second quarter of fiscal year 2010, total company gross margin percentage was flat compared to the second quarter of fiscal year 2009 as the increase in gross margin for Oncology Systems was offset by declines in X-ray Products and SIP gross margin. Total company gross margin percentage for the first half of fiscal year 2010 increased 0.7 percentage points over the first half of fiscal year 2009, primarily due to the increase in Oncology Systems gross margin, partially offset by declines in X-ray Products and SIP gross margin.

Oncology Systems gross margin percentage increased in the second quarter and the first half of fiscal year 2010 over the respective year-ago periods primarily due to an increase in service gross margin and, to a lesser extent, an increase in product gross margin. For the second quarter of fiscal year 2010, Oncology Systems service contract gross margin increased to 47.7% from 45.3% in the second quarter of fiscal year 2009. For the first half of fiscal year 2010, Oncology Systems service contract gross margin increased to 51.8% from 46.3% in the first half of fiscal year 2009. The increases in Oncology Systems service contract gross margin for the second quarter and the first half of fiscal year 2010 over the respective year-ago periods were mainly due to higher service contract volume, cost control initiatives and lower quality costs. For the second quarter of fiscal year 2010, Oncology Systems product gross margin increased to 44.2% from 43.6% in the second quarter of fiscal year 2009. For the first half of fiscal year 2010, Oncology Systems product gross margin increased to 43.5% from 43.1% in the same period of fiscal year 2009. The increases in Oncology Systems product gross margin for the second quarter and the first half of fiscal year 2010 over the respective year-ago periods were primarily due to a product mix shift toward higher margin software products. The weaker U.S. dollar against foreign currencies in the second quarter and the first half of fiscal year 2010 compared to the same periods of fiscal year 2009, which favorably affected our international revenues when measured in U.S. dollars, also contributed to the increases in our Oncology Systems product and service gross margins.

For the second quarter and the first half of fiscal year 2010, X-ray Products gross margin percentage decreased from the second quarter and the first half of fiscal year 2009 primarily due to a product mix shift toward lower margin products and start up costs related to our new radiographic flat panel products.

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

(Dollars in millions)	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
Research and development	\$ 38.9	\$ 37.0	5%	\$ 77.3	\$ 74.0	5%
<i>As a percentage of total revenues</i>	<i>6.7%</i>	<i>6.7%</i>		<i>6.9%</i>	<i>7.0%</i>	

The \$1.9 million increase in research and development expense for the second quarter of fiscal year 2010 over the second quarter of fiscal year 2009 was driven by increased expenses of \$2.2 million in the Other category and \$0.6 million in Oncology Systems, partially offset by decreased expenses of \$0.9 million in X-ray Products. The \$2.2 million increase in the Other category was primarily attributable to higher expenses for development projects in Varian Particle Therapy. The \$0.6 million increase in Oncology Systems was primarily due to a \$0.9 million unfavorable currency translation impact, as foreign currency denominated research and development expenses for Oncology Systems were translated into weaker U.S. dollars. The \$0.9 million decrease in X-ray Products was mainly due to lower development expenses for flat panel products.

The \$3.3 million increase in research and development expense for the first half of fiscal year 2010 over the first half of fiscal year 2009 was driven by increased expenses of \$2.9 million in Oncology Systems and \$2.4 million in the Other category, partially offset by a decrease of \$2.0 million in X-ray Products. The \$2.9 million increase in Oncology Systems was primarily attributable to a \$2.3 million unfavorable currency translation impact, as foreign currency denominated research and development expenses for Oncology Systems were translated into weaker U.S. dollars, as well as an increase in material costs and consulting expenses for product development. The \$2.4 million increase in the Other category was primarily due to higher expenses for development projects in Varian Particle Therapy. The \$2.0 million decrease in X-ray Products was mainly due to lower development expenses for both flat panel products and x-ray tubes.

**Selling, General and Administrative**

(Dollars in millions)	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
Selling, general and administrative	\$ 79.5	\$ 81.2	(2%)	\$ 163.0	\$ 164.4	(1%)
<i>As a percentage of total revenues</i>	<i>13.6%</i>	<i>14.7%</i>		<i>14.5%</i>	<i>15.5%</i>	

Selling, general and administrative expenses decreased in the second quarter and the first half of fiscal year 2010 compared to the same periods in fiscal year 2009, primarily due to cost control initiatives. As a percentage of total revenues, selling, general and administrative expenses in the second quarter and the first half of fiscal year 2010 decreased about one-percentage point from the year-ago periods.

The \$1.7 million reduction in selling, general and administrative expenses for the second quarter of fiscal year 2010 compared to the second quarter of fiscal year 2009 was primarily attributable to a \$2.6 million net decrease in employee-related costs due to cost control initiatives.

The \$1.4 million reduction in selling, general and administrative expenses for the first half of fiscal year 2010 compared to the first half of fiscal year 2009 was primarily attributable to: (a) a \$5.3 million net decrease in employee-related costs due to cost control initiatives; and (b) a decrease in information technology expenses of \$4.8 million primarily due to the completion of the implementation of our enterprise resource planning system in the second quarter of fiscal year 2009. These reductions were partially offset by: (i) an expense of \$3.1 million related to a reduction in force that occurred in October 2009; (ii) unfavorable foreign currency impact of \$2.5 million as the foreign currency denominated selling, general and administrative expenses of our foreign operations were translated into weaker U.S. dollars; (iii) a \$2.2 million increase in fees for certain commission arrangements and product promotions which were primarily tied to growth in Oncology Systems revenue; and (iv) a \$1.5 million increase in depreciation expenses for our enterprise resource planning system that was placed in service in the second quarter of fiscal year 2009.



**Table of Contents****Interest Income (Expense), Net**

(Dollars in millions)	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
Interest income (expense), net	\$ (0.4)	\$ (0.3)	20%	\$ (0.7)	\$ 1.0	(168%)

The decrease in interest income (expense), net, in the second quarter and the first half of fiscal year 2010 compared to the second quarter and the first half of fiscal year 2009, respectively, was primarily due to the lower average interest rates earned on our cash and cash equivalents in the fiscal year 2010 periods.

**Taxes on Earnings**

	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
Effective tax rate	32.6%	34.9%	(2.3%)	33.1%	32.9%	0.2%

The decrease in our effective tax rate in the second quarter of fiscal year 2010 over the year-ago quarter was primarily due to a shift in the geographic mix of earnings. For the first half of fiscal year 2010, the slight increase in our effective tax rate over the year-ago period was primarily due to a greater benefit from discrete items in the first half of fiscal year 2009. For example, the earlier period included the benefit of the retroactive reinstatement of the federal research and development credit.

In general, our effective income tax rate differs from the U.S. federal statutory rate primarily because our foreign earnings are taxed at rates that are, on average, lower than the U.S. federal rate, and our domestic earnings are subject to state income taxes. Our future effective tax rate could be adversely affected by having lower earnings than anticipated in countries where we have lower statutory rates and higher earnings than anticipated in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets or liabilities, and by changes in tax laws or interpretations of those laws. For example, recent proposals would make significant changes to U.S. taxation of U.S.-based multinational corporations. Although we cannot predict whether or in what form Congress would enact any such proposals, legislation of this type could have an adverse impact on our effective tax rate. We also expect that our effective tax rate may fluctuate more from period to period under the provisions in ASC 740 related to accounting for uncertainty in income taxes. Please refer to further discussion in Note 13 Income Taxes of the Notes to the Consolidated Financial Statements in our 2009 Annual Report.

**Net Earnings Per Diluted Share**

	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
Net earnings per diluted share	\$ 0.73	\$ 0.64	14%	\$ 1.36	\$ 1.19	14%

The increase in earnings per diluted share in the second quarter of fiscal year 2010 over the second quarter of fiscal year 2009 resulted from (i) an increase in total revenues, (ii) a decrease in our operating expenses as a percent of revenues and (iii) a decrease in our effective tax rate. The increase in earnings per diluted share in the first half of fiscal year 2010 over the first half of fiscal year 2009 resulted from (i) an increase in total revenues, (ii) an improvement in gross margin, and (iii) a decrease in our operating expenses as a percent of revenues.

**Table of Contents****Net Orders**

Total Net Orders (by segment and region) (Dollars in millions)	Three Months Ended			Six Months Ended		
	April 2, 2010	April 3, 2009	Percent Change	April 2, 2010	April 3, 2009	Percent Change
<b>Oncology Systems:</b>						
North America	\$ 199.0	\$ 226.8	(12%)	\$ 390.0	\$ 447.3	(13%)
Total International	277.2	207.4	34%	522.7	414.5	26%
Total Oncology Systems	\$ 476.2	\$ 434.2	10%	\$ 912.7	\$ 861.8	6%
<b>X-ray Products:</b>						
North America	\$ 35.6	\$ 26.9	33%	\$ 46.3	\$ 53.6	(14%)
Total International	69.1	41.9	65%	157.4	106.3	48%
Total X-ray Products	\$ 104.7	\$ 68.8	52%	\$ 203.7	\$ 159.9	27%
<b>Other:</b>	\$ 12.3	\$ 21.2	(42%)	\$ (27.6)	\$ 53.8	(151%)
<b>Total Net Orders:</b>	\$ 593.2	\$ 524.2	13%	\$ 1,088.8	\$ 1,075.5	1%

Net orders in the second quarter of fiscal year 2010 increased compared to the second quarter of fiscal year 2009 primarily due to the increase in net orders from Oncology Systems and X-ray Products, partially offset by the decrease in SIP net orders. The international region was the main contributor to net order growth in Oncology Systems and X-ray Products in the second quarter of fiscal year 2010 over the year-ago quarter. Total net orders for the first half of fiscal year 2010, which included the reversal of a \$62 million proton therapy system order from Skandion Kliniken (as described further below), increased 1% from the year-ago period with net order increases from Oncology Systems and X-ray Products, nearly offset by net order decreases from Varian Particle Therapy and SIP. When measured in constant currency, total net orders increased 10% for the second quarter of fiscal year 2010 and decreased 2% for the first half of fiscal year 2010.

For the second quarter and the first half of fiscal year 2010, the increase in total Oncology Systems net orders over the respective year-ago periods was driven by the net order growth in the international region, which was partially offset by the decrease in North American net orders. When measured in constant currency, total Oncology Systems net orders increased 6% for the second quarter of fiscal year 2010 and 1% for the first half of fiscal year 2010.

The growth in Oncology Systems international net orders for the second quarter and the first half of fiscal year 2010 was primarily due to increased demand for our linear accelerators and our software products as well as growth in demand for our service contracts. We saw double-digit growth in all international regions for the quarter and the year-to-date period. When measured in constant currency, international Oncology Systems net orders increased 26% for the second quarter of fiscal year 2010 and 18% for the first half of fiscal year 2010.

For the second quarter and the first half of fiscal year 2010, North American net orders for most of Oncology Systems product lines decreased over the respective year-ago periods. North America declined as a result of smaller capital budgets that were established in response to uncertainty created by the recession and healthcare reform in the United States.

The trailing 12 months growth in net orders for Oncology Systems at the end of the second quarter of fiscal year 2010 and at the end of the previous three fiscal quarters were: flat for total Oncology Systems net orders, with a 14% decrease in North America and an 18% increase for the international region, as of April 2, 2010; a 1% total decrease, with an 11% decrease in North America and an 11% increase for the international region, as of January 1, 2010; a 1% total increase, with a 7% decrease in North America and an 11% increase for the international region, as of October 2, 2009; an 8% total increase, with a 5% increase in North America and a 13% increase for the international region, as of July 3, 2009. Consistent with the historical pattern, we expect that Oncology Systems net orders will continue to experience regional fluctuations.

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Net orders for X-ray Products grew 52% in the second quarter of fiscal year 2010 over the second quarter of fiscal year 2009, and increased 27% in the first half of fiscal year 2010 over the first half of fiscal year 2009. Increased demand for flat panel products in Asia, as well as increased demand for our x-ray tubes in all international regions, contributed to the growth in

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international X-ray Products net orders in the second quarter of fiscal year 2010 over the year-ago quarter. The growth in North American net orders in the second quarter of fiscal year 2010 over the year-ago quarter was primarily due to the increase in demand for our flat panel products, especially our radiographic flat panels, and to a lesser extent, increased demand for our x-ray tubes products. For the first half of fiscal year 2010, both our flat panel and x-ray tubes product lines reported growth in international net orders and declines in North American net orders over the year-ago period.

The decrease in net orders in the *Other* category in the second quarter of fiscal year 2010 from the second quarter of fiscal year 2009 was primarily due to the decrease in net orders for SIP products as this business experienced some delays in large orders. Net orders in the *Other* category declined \$81 million for the first half of fiscal year 2010 over the year-ago period primarily due to the cancellation of a \$62 million proton therapy system order from Skandion Kliniken and, to a lesser extent, a decrease in SIP net orders from very strong SIP net orders in the year-ago period. We booked the order from Skandion Kliniken in the fourth quarter of fiscal year 2009 when Skandion Kliniken awarded us a contract to deliver and install a proton therapy system in Sweden following a public tender process, which was subsequently challenged by a competitor. After the Swedish court ruled in December 2009 that the tender should be recommenced, Skandion Kliniken cancelled the award with us in January 2010. In accordance with our order booking policy, we removed this order from our backlog in the first fiscal quarter of 2010. For our Varian Particle Therapy business, we recognize orders when construction of the related proton therapy treatment center is reasonably expected to start within two years. Also, we only recognize orders for Varian Particle Therapy products with contingencies if we deem the contingencies perfunctory or if we publicly disclose the existence and nature of material contingencies. However, orders will not be recognized if there are major financing contingencies or customer board approval contingencies pending.

Our net orders have been and may continue to be impacted by the effects of the recent economic downturn and by uncertainty created by healthcare reform in the United States, which shrunk capital equipment budgets and made financing for large equipment purchases more expensive. As hospital budgets return to more normal levels and there is greater clarity on the impact of the Affordable Health Care for America Act, we could experience a temporary increase in orders due to pent-up demand of customers, which in turn could increase the volatility of our orders and revenues. Orders in any period may not be directly correlated to the level of revenues in any particular future quarter or period since the timing of revenue recognition will vary significantly based on the delivery requirements of individual orders, acceptance schedules and the readiness of individual customer sites for installation of our products. Moreover, certain types of orders, such as software products or newly introduced products in our Oncology Systems segment, typically take more time from order to completion of installation and acceptance.

***Discontinued Operations***

In the fourth quarter of fiscal year 2008, we approved a plan to sell Research Instruments to focus the business that we acquired from ACCEL exclusively on the development of our Varian Particle Therapy business. The sale of Research Instruments was completed in the second quarter of fiscal year 2009. Research Instruments has been classified as a discontinued operation in our Condensed Consolidated Statements of Earnings for all periods presented. Research Instruments was previously included in the *Other* category. Revenues from Research Instruments were \$0.1 million and \$0.2 million for the second quarter and the first half of fiscal year 2010, respectively. For the second quarter and the first half of fiscal year 2009, revenues from Research Instruments were \$4.8 million and \$9.0 million, respectively. Research Instruments did not have any profit or loss in the second quarter and the first half of fiscal year 2010. Including a net loss on the disposal of Research Instruments of \$8.1 million, net loss from Research Instruments was \$11.5 million for the second quarter of fiscal year 2009 and \$12.3 million for the first half of fiscal 2009. See Note 16, *Discontinued Operations* to the Condensed Consolidated Financial Statements for a detailed discussion.

***Backlog***

At April 2, 2010, our backlog was \$2.0 billion, which was an increase of 6% over the backlog at April 3, 2009. Our Oncology Systems backlog at April 2, 2010 was 5% higher than the backlog at April 3, 2009, which reflects a 14% increase for the international region and is flat for North America.

**Table of Contents****Liquidity and Capital Resources**

Liquidity is the measurement of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, acquire businesses and fund continuing operations. Our sources of cash have included operations, borrowings, stock option exercises and employee stock purchases (although no purchases under our employee stock purchase plan have been made during fiscal year 2010) and interest income. Our cash usage is actively managed on a daily basis to ensure the maintenance of sufficient funds to meet our needs. Because Research Instruments cash flows were not material for any period presented, we have not segregated them from continuing operations on our Condensed Consolidated Statements of Cash Flows and the discussion herein.

**Cash and Cash Equivalents**

The following table summarizes our cash and cash equivalents:

(In millions)	April 2, 2010	October 2, 2009	Increase/ (Decrease)
Cash and cash equivalents	\$ 655	\$ 554	\$ 101

Our cash and cash equivalents increased \$101 million from \$554 million at October 2, 2009 to \$655 million at April 2, 2010. The increase in cash and cash equivalents in the first six months of fiscal year 2010 was due primarily to \$224 million of cash generated from operating activities, \$28 million of cash provided by stock option exercises and \$5 million of cash provided by the excess tax benefits from share-based compensation. These increases were partially offset by \$127 million used for the repurchase of VMS common stock, \$19 million of capital expenditures, \$7 million for tendered VMS common stock used to satisfy employee tax withholding requirements at vesting of restricted common stock and restricted stock units, \$4 million used for net repayment under our line of credit agreement, \$3 million used for repaying bank borrowings. In addition, foreign currency exchange rate changes in the first six months of fiscal year 2010 increased cash and cash equivalents by \$7 million.

At April 2, 2010, we had approximately \$62 million, or 9%, of total cash and cash equivalents in the United States. Approximately \$593 million, or 91%, of total cash and cash equivalents was held abroad and could be subject to additional taxation if it were repatriated to the United States. As of April 2, 2010, most of our cash and cash equivalents that were held abroad were in U.S. dollars. Because our cash levels in the United States are relatively low, we have used our credit facility to meet our U.S. cash needs from time to time and expect to continue to do so in the future. Borrowings under our credit facility may be used for working capital, capital expenditures, acquisitions and other corporate purposes.

**Cash Flows**

(In millions)	Six Months Ended	
	April 2, 2010	April 3, 2009
Net cash flow provided by (used in):		
Operating activities	\$ 224	\$ 60
Investing activities	(23)	(42)
Financing activities	(107)	(52)
Effects of exchange rate changes on cash and cash equivalents	7	12
Net increase in cash and cash equivalents	\$ 101	\$ (22)

Our primary cash inflows and outflows for the first six months of fiscal year 2010, as compared to the first six months of fiscal year 2009, were as follows:

In the first six months of fiscal year 2010, we generated net cash from operating activities of \$224 million, compared to \$60 million for the first six months of fiscal year 2009.

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The \$164 million increase in net cash from operating activities during the first six months of fiscal year 2010 compared to the first six months of fiscal year 2009 was driven primarily by a net change of \$137 million in

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operating assets and liabilities (working capital items) and an increase of \$33 million in net earnings, partially offset by a decrease of \$6 million in non-cash items.

The major contributors to the net change in working capital items in the first six months of fiscal year 2010 were accounts receivable, inventories, advance payments from customers, accrued liabilities and prepaid expenses and other current assets as follows:

Accounts receivable decreased \$69 million due to strong collection performance in the first six months of fiscal year 2010.

Inventories increased by \$58 million primarily due to increased inventories in Oncology Systems and X-ray Products in anticipation of customer demand for products during fiscal year 2010.

Advance payments from customers increased by \$39 million due to the timing of advance payments received.

Accrued liabilities decreased \$22 million primarily due to the decrease in income taxes payable as a result of tax payments made in the first six months of fiscal year 2010.

Prepaid expenses and other current assets increased by \$15 million due to timing of expense payments.

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, timing of product shipments and customer acceptance, accounts receivable collections, inventory management and the timing and amount of tax and other payments. For additional discussion, please refer to the Risk Factors in Item 1A.

We used \$23 million for investing activities in the first six months of fiscal year 2010, primarily for purchases of property, plant and equipment of \$19 million. We used \$42 million in the first six months of fiscal year 2009, which included \$29 million used for purchases of property, plant and equipment and \$6 million used for a loan to dpiX LLC.

Financing activities used net cash of \$107 million in the first six months of fiscal year 2010 compared to \$52 million in the first six months of fiscal year 2009. During the first six months of fiscal year 2010, we used \$127 million to repurchase shares of VMS common stock, \$7 million for tendered VMS common stock to satisfy employee tax withholding requirements at vesting of restricted common stock and restricted stock units, \$4 million for net repayment under our line of credit agreement, and \$3 million for repaying bank borrowings. Partially offsetting these uses were proceeds of \$28 million from employee stock option exercises, and \$5 million in excess tax benefits from share-based compensation. During the first six months of fiscal year 2009, we used \$72 million to repurchase shares of VMS common stock, \$8 million to repay bank borrowings and \$3 million for tendered VMS common stock used to satisfy employee tax withholding requirements at vesting of restricted common stock. Partially offsetting these uses were proceeds of \$14 million from employee stock option exercises and employee stock purchases, \$10 million in net borrowing under our credit facility, and \$6 million in excess tax benefits from share-based compensation.

We expect our capital expenditures, which typically represent construction and/or purchases of facilities, manufacturing equipment, office equipment and furniture and fixtures, as well as capitalized costs related to the implementation of software applications, will be approximately 3.6% of revenues in fiscal year 2010.

We have a \$150 million credit facility with Bank of America, N.A. ( BofA ), which was amended and restated in November 2008 and in July 2009. This credit facility, as amended and restated, is referred to as the Amended BofA Credit Facility. The July 2009 amendment to the Amended BofA Credit Facility (the Japanese Line of Credit ) enabled VMS's Japanese subsidiary ( VMS KK ) to borrow up to 2.7 billion Japanese Yen. At any time amounts are outstanding under the Japanese Line of Credit, the full borrowing capacity under the Japanese Line of Credit is deemed committed for use in Japan and therefore the maximum amount VMS can otherwise borrow under the Amended BofA Credit Facility will be reduced by \$30 million to \$120 million. VMS guarantees the payment of the outstanding balance under the Japanese Line of Credit. We

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collateralized a portion of the Amended BofA Credit Facility with a pledge of stock of certain present and future subsidiaries that are deemed to be material subsidiaries under its terms. As of April 2, 2010, we had pledged to BofA 65% of the voting shares that we hold in Varian Medical Systems Nederland B.V., a wholly-owned subsidiary.



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The Amended BofA Credit Facility may be used for working capital, capital expenditures, permitted acquisitions and other lawful corporate purposes. Borrowings under the Japanese Line of Credit can be used by VMS KK for refinancing certain intercompany debts, working capital, capital expenditures and other lawful corporate purposes. Borrowings under the Amended BofA Credit Facility (outside of the Japanese Line of Credit) accrue interest either (i) based on LIBOR plus a margin of 1.25% to 1.50% based on a leverage ratio involving funded indebtedness and earnings before interest, taxes, depreciation and amortization ( EBITDA ) or (ii) based upon a base rate of either the federal funds rate plus 0.5% or BofA's announced prime rate, whichever is greater, minus a margin of 0.5% to 0% based on a leverage ratio involving funded indebtedness and EBITDA (depending upon our instructions to BofA). We may select borrowing periods of one, two, three or six months for advances based on the LIBOR rate. Interest rates on advances based on the base rate are adjustable daily. Borrowings under the Japanese Line of Credit accrue interest at the basic loan rate announced by the Bank of Japan plus a margin of 1.25% to 1.50% based on a leverage ratio involving funded indebtedness and EBITDA. The Amended BofA Credit Facility will expire, if not extended by mutual agreement of VMS and BofA, on November 10, 2011. The Japanese Line of Credit will expire on November 10, 2010.

As of April 2, 2010, there was no outstanding balance under the Amended BofA Credit Facility. The Amended BofA Credit Facility contains customary affirmative and negative covenants for facilities of this type. We have also agreed to maintain certain financial covenants relating to (i) leverage ratios involving funded indebtedness and EBITDA, (ii) liquidity and (iii) consolidated assets. As of April 2, 2010, we were in compliance with all covenants. See also Note 7 Credit Facility to the Condensed Consolidated Financial Statements for a discussion regarding the credit facility.

Our liquidity is affected by many factors, some of which result from the normal ongoing operations of our business and some of which arise from uncertainties and conditions in the United States and global economies. Although our cash requirements will fluctuate as a result of the shifting influences of these factors, we believe that existing cash and cash equivalents and cash to be generated from operations and current or future credit facilities will be sufficient to satisfy anticipated commitments for capital expenditures and other cash requirements for the next 12 months. We currently anticipate that we will continue to utilize our available liquidity and cash flows from operations, as well as borrowed funds, to make strategic acquisitions, invest in the growth of our business, invest in advancing our systems and processes and repurchase VMS common stock.

Total debt as a percentage of total capital decreased to 2.1% at April 2, 2010 from 2.7% at October 2, 2009 due to the repayment of bank borrowings and net repayment under the Amended BofA Credit Facility. The ratio of current assets to current liabilities increased to 2.11 to 1 at April 2, 2010 from 1.99 to 1 at October 2, 2009.

### ***Days Sales Outstanding***

Trade accounts receivable days sales outstanding ( DSO ) were 76 days at April 2, 2010 compared to 87 days at April 3, 2009. Our accounts receivable and DSO are impacted by a number of factors, including primarily: the timing of product shipments; collections performance; payment terms; and the mix of revenues from different regions. As of April 2, 2010, less than 1% of our accounts receivable balance was related to customer contracts with extended payment terms of more than one year.

### ***Stock Repurchase Program***

On November 17, 2008, VMS's Board of Directors authorized the repurchase of 8,000,000 shares of VMS common stock from January 1, 2009 through December 31, 2009. On November 13, 2009, the Company's Board of Directors authorized the repurchase of an additional 5,000,000 shares of VMS common stock from January 1, 2010 through December 31, 2010. During the first half of fiscal year 2010, we paid \$127 million to repurchase 2,700,000 shares of VMS common stock, of which \$72 million was paid during the second quarter of fiscal year 2010 to repurchase 1,450,000 shares. All shares that have been repurchased have been retired. The November 17, 2008 authorization expired on December 31, 2009 with 6,050,000 shares available for repurchase. As of April 2, 2010, we could repurchase up to an additional 3,550,000 shares of VMS common stock under the November 13, 2009 authorization.

### ***Contractual Obligations***

Long-term income taxes payable includes the liability for uncertain tax positions (including interest and penalties) and may also include other long-term tax liabilities. As of April 2, 2010, our liability for uncertain tax positions was \$55.1 million. We believe that existing cash and cash equivalents and cash to be generated from operations and current or future credit facilities will be sufficient to satisfy any payment obligations that may arise related to our liability for uncertain tax positions.



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In February 2009, we agreed to loan \$14 million to dpiX in four separate installments over a period through the first half of fiscal year 2010, which period could be extended. As of April 2, 2010, we had loaned \$8.8 million to dpiX under this loan agreement and we expect to loan the remaining \$5.2 million in fiscal year 2010. Please refer to the more detailed discussion in Note 5, *Related Party Transactions* to the Condensed Consolidated Financial Statements.

Except for the items discussed above and the change in the outstanding balance under our credit facility, there has been no significant change to the other contractual obligations we reported in our 2009 Annual Report.

### ***Contingencies***

#### **Environmental Remediation Liabilities**

For a discussion of environmental remediation liabilities, see Note 9, *Commitments and Contingencies - Environmental Remediation Liabilities* to the Condensed Consolidated Financial Statements, which discussion is incorporated herein by reference.

#### **Acquisition-Related Commitments/Obligations**

When we acquired ACCEL in January 2007, ACCEL was involved in a contract-related lawsuit, which we settled by agreeing to perform certain services for a fixed price contract (the *Fixed Price Contract*). As of October 2, 2009, we had recorded a loss accrual of 7.6 in relation to Fixed Price Contract. In the first quarter of fiscal year 2010, we entered into a new contract (the *New Contract*) to perform certain services for a fixed price and we recorded a loss accrual of 0.9 million in connection with the New Contract. As of April 2, 2010, the balance of the loss accrual related to this contingency (the *New Contract*) was 0.6 million. 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 Statement of Earnings in the periods these variances arise.

### **Other Matters**

We are involved, from time to time, in legal proceedings, claims and government inspections or investigations, arising in the ordinary course of our business. Such matters are subject to many uncertainties and outcomes are not predictable with assurance. We accrue amounts, to the extent they can be reasonably estimated, that we believe are adequate to address any liabilities related to legal proceedings and other loss contingencies that we believe will result in a probable loss. While we cannot assure you as to the ultimate outcome of any legal proceeding or other loss contingency involving us, management does not believe any pending matter will be resolved in a manner that would have a material adverse effect on our consolidated financial position, results of operations or cash flows. However, it is possible that a legal or other proceeding brought against us could have an impact of this nature.

### **Off-Balance Sheet Arrangements**

In conjunction with the sale of our products in the ordinary course of business, we provide standard indemnification of business partners and customers for losses suffered or incurred for property damages, death and injury and for patent, copyright or any other intellectual property infringement claims by any third parties with respect to our products. The term of these indemnification arrangements is generally perpetual. Except for losses related to property damages, the maximum potential amount of future payments we could be required to make under these agreements is unlimited. As of April 2, 2010, we have not incurred any significant costs to defend lawsuits or settle claims related to these indemnification arrangements since we spun off Varian Inc. and Varian Semiconductor Equipment Associates, Inc. in 1999.

We have entered into indemnification agreements with our directors and officers and certain of our employees that serve as officers or directors of our foreign subsidiaries that may require us to indemnify our directors and officers and those certain employees against liabilities that may arise by reason of their status or service as directors or officers, and to advance their expenses incurred as a result of any legal proceeding against them as to which they could be indemnified. Generally, the maximum obligation under these indemnifications is not explicitly stated and, as a result, the overall amount of these obligations cannot be reasonably estimated.

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### ***Recent Accounting Pronouncements***

In December 2008, the Financial Accounting Standards Board ( FASB ) issued new standards under ASC 715-20, which provides guidance on an employer's disclosure about plan assets of a defined benefit pension or other post-retirement plan and requires employers to disclose information about fair value measurements of plan assets. The new standards under ASC 715-20 will be effective for us as of the end of fiscal year 2010. The adoption of these new standards concerns disclosure only and we do not expect it to have an impact on our consolidated financial position, results of operations or cash flows.

In June 2009, the FASB issued the consolidation guidance for variable-interest entities to replace the quantitative-based risks and rewards calculation for determining which enterprise, if any, has a controlling financial interest in a variable-interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable-interest entity that most significantly impact the entity's economic performance. These new standards will be effective for us in the first quarter of fiscal year 2011. We are currently assessing the potential impact, if any, these new standards may have on our consolidated financial position, results of operations and cash flows.

In March 2010, the FASB issued the guidance related to the Milestone Method of Revenue Recognition ( ASU 2010-17 ), which recognizes the milestone method as an acceptable revenue recognition method for substantive milestones in research or development transaction. ASU 2010-17 is effective in fiscal years beginning on or after June 15, 2010, with early adoption permitted. We are currently assessing the potential impact, if any, ASU 2010-17 may have on our consolidated financial position, results of operations and cash flows.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to three primary types of market risks: credit risk, foreign currency exchange rate risk and interest rate risk.

#### **Credit Risk**

The general worldwide economic downturn and resulting contraction in the credit markets exposes us to additional credit risk. We are exposed to credit loss in the event of nonperformance by counterparties on the foreign exchange contracts used in hedging activities. These counterparties are large international financial institutions and to date, no such counterparty has failed to meet its financial obligation under such contracts. In addition, cash and cash equivalents held with financial institutions may exceed the Federal Deposit Insurance Corporation insurance limits or similar limits in foreign jurisdictions. We also may need to rely on the credit facility described below. Our access to our cash and cash equivalents or ability to borrow could be reduced if one or more financial institutions with which we have deposits or from which we borrow should fail or otherwise be adversely impacted by conditions in the financial or credit markets.

#### **Foreign Currency Exchange Rate Risk**

As a global entity, we are exposed to movements in foreign currency exchange rates. These exposures may change over time as business practices evolve. Adverse movements could have a material negative impact on our financial results. Our primary exposures related to foreign currency denominated sales and purchases are in Europe, Asia, Australia and Canada.

We have many transactions denominated in foreign currencies and address certain of those financial exposures through a risk management program that includes the use of derivative financial instruments. We sell products throughout the world, often in the currency of the customer's country, and may hedge certain of these larger foreign currency transactions when they are not transacted in the subsidiaries' functional currency. The foreign currency sales transactions that fit our risk management policy criteria are hedged with forward contracts. We may use other derivative instruments in the future. We enter into foreign currency forward contracts primarily to reduce the effects of fluctuating foreign currency exchange rates. We do not enter into forward contracts for speculative or trading purposes. The forward contracts range from one to twelve months in maturity.

We also hedge the balance sheet exposures from our various foreign subsidiaries and business units. We enter into foreign currency forward contracts to minimize the short-term impact of currency fluctuations on assets and liabilities denominated in currencies other than the U.S. dollar functional currency.

The notional values of our sold and purchased foreign currency forward contracts outstanding as of April 2, 2010 were \$316.4 million and \$51.4 million, respectively. The notional amounts of forward contracts are not a measure of our exposure. The fair value of forward contracts generally reflects the estimated amounts that we would receive or pay to



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terminate the contracts at the reporting date, thereby taking into account and approximating the current unrealized and realized gains or losses of the open contracts. A move in foreign currency exchange rates would change the fair value of the contracts, and the fair value of the underlying exposures hedged by the contracts would change in a similar offsetting manner.

### **Interest Rate Risk**

Our market risk exposure to changes in interest rates depends primarily on our investment portfolio and short-term borrowings. Our investment portfolio consisted of cash and cash equivalents as of April 2, 2010. The principal amount of cash and cash equivalents at April 2, 2010 totaled \$655 million with a weighted average interest rate of 0.18%.

The Amended BofA Credit Facility (including the Japanese Line of Credit) allows us to borrow up to a maximum amount of \$150 million. We collateralized a portion of the Amended BofA Credit Facility with a pledge of 65% of the voting shares that we hold in Varian Medical Systems Nederland B.V., a wholly-owned subsidiary. Borrowings under the Amended BofA Credit Facility (outside of the Japanese Line of Credit) accrue interest based on the LIBOR, the federal funds rate, or the BofA's prime rate plus a margin. Borrowings under the Japanese Line of Credit accrue interest at the basic loan rate announced by the Bank of Japan plus a margin.

We are affected by market risk exposure primarily through the effect of changes in interest rates on amounts payable under the Amended BofA Credit Facility (including the Japanese Line of Credit). As of April, 2010, there was no outstanding balance under the Amended BofA Credit Facility. See a detailed discussion of our credit facility under "Liquidity and Capital Resources" section in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

In addition, we had \$29.8 million of long-term debt (including the current maturities of long-term debt) outstanding as of April 2, 2010 that carried at a weighted average fixed interest rate of 6.9% with principal payments due in various installments over a four-year period. To date, we have not used derivative financial instruments to hedge the interest rate of our investment portfolio, short-term borrowings or long-term debt, but may consider the use of derivative instruments in the future.

The estimated fair value of our cash and cash equivalents (91% of which was held abroad at April 2, 2010 and could be subject to additional taxation if it were repatriated to the United States) and the estimated fair value of our short-term borrowings under the credit facility approximated the principal amounts reflected above based on the maturities of these financial instruments.

Although payments under certain of our operating leases for our facilities are tied to market indices, these operating leases do not expose us to material interest rate risk.

## **Item 4. Controls and Procedures**

- (a) **Disclosure controls and procedures.** Based on the evaluation of our disclosure controls and procedures (as defined in the Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) required by Exchange Act Rules 13a-15(b) or 15d-15(b), our principal executive officer and principal financial officer have concluded that as of the end of the period covered by this report, our disclosure controls and procedures were effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and include controls and procedures designed to ensure that information required to be disclosed by us in such reports is accumulated and communicated to our management, including the principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.
- (b) **Changes in internal control over financial reporting.** There were no changes in our internal control over financial reporting that occurred during the second quarter of fiscal year 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II**

**OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are subject to various legal proceedings and claims that are discussed in Note 9, Commitments and Contingencies to the Condensed Consolidated Financial Statements, which discussion is incorporated by reference into this item.

**Item 1A. Risk Factors**

The following risk factors and other information included in this Quarterly Report on Form 10-Q and in our 2009 Annual Report should be carefully considered. Although the risk factors described below are the ones management deems significant, additional risks and uncertainties not presently known to us or that we presently deem less significant may also impair our business operations. If any of the following risks actually occur, our business, operating results, and financial condition could be adversely affected.

***IF WE ARE UNABLE TO ANTICIPATE OR KEEP PACE WITH CHANGES IN THE MARKETPLACE AND THE DIRECTION OF TECHNOLOGICAL INNOVATION AND CUSTOMER DEMANDS, OUR PRODUCTS MAY BECOME LESS USEFUL OR OBSOLETE AND OUR OPERATING RESULTS WILL SUFFER***

Rapid change and technological innovation characterize the Oncology Systems market. Our products often have long development and government approval cycles, so we must anticipate changes in the marketplace, in technology and in customer demands.

We believe that IMRT and IGRT have become accepted standards for treatment in the radiation oncology market. Demand for our IMRT and IGRT products have been historical drivers for our net orders and revenues in Oncology Systems, and our future success depends on the continued acceptance of these standards and our products. We recently introduced UNIQUE and TrueBeam, new products and product lines designed to meet the evolving needs of our customers. Acceptance of these new products and products lines are key to our future success. If our customers do not purchase these products or if future studies call into question the effectiveness of our IMRT or IGRT products in general, or our UNIQUE and TrueBeam products in particular, or show negative side effects, or if other more effective technologies are introduced, our net orders, revenues and financial results could suffer. As more institutions buy or upgrade to achieve these capabilities, the market for IMRT and IGRT products may become saturated and we could face competition from newer technologies.

We also believe that the acceptance of VMAT in general, and our RapidArc products in particular, is another key to our future success. We believe that our RapidArc products for VMAT are a significant advance in IMRT treatments and can help drive longer term demand for our linear accelerators and IMRT-related products. Orders for our RapidArc technology have contributed significantly to our net orders growth. If future studies contradict current knowledge about VMAT or our RapidArc products, question the effectiveness of VMAT treatments or show negative side effects, or if other more effective technologies are introduced, our customers may not be willing to adopt VMAT or purchase our RapidArc products. In addition, if third party information systems do not support our VMAT technology, customers that have third party information systems may not purchase our RapidArc products, which could negatively impact our net orders and revenues.

As radiation oncology treatment becomes more complex, our customers are increasingly focusing on ease-of-use and interconnectivity. Our equipment and software is highly sophisticated and requires a high level of training and education to use them competently and safely, a requirement made even more important because they work together within integrated environments. We have directed substantial product development efforts into (i) greater interconnectivity of our products for more seamless operation within a system, (ii) enhancing the ease of use of our software products and (iii) reducing setup and treatment times and increasing patient throughput. We have emphasized maintaining an open systems approach that allows customers to mix and match individual products, incorporate products from other manufacturers, share information with other systems or products and use the equipment for offering various methods of radiation therapy treatment. We anticipate that these efforts will increase the acceptance and adoption of IMRT, IGRT and VMAT and will stimulate demand for our products. We face competition though from closed-ended dedicated-use systems that place simplicity of use ahead of flexibility. If we have misjudged the importance to our customers of maintaining an open systems approach, or if we are unsuccessful in our efforts to enable greater interconnectivity, enhance ease-of-use and reduce setup and treatment times, our revenues could suffer.





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The acquisition of Varian Particle Therapy should enable us to develop and offer products for delivering image-guided, intensity-modulated proton therapy for the treatment of cancer. Our future success will depend upon the wide-spread awareness, acceptance and adoption by the oncology market of proton therapy systems for the treatment of cancer. However, this technology may not be accepted as quickly as others due to the relatively large scale, high costs and complex project financing associated with implementing a proton therapy system. Risks associated with this business could increase, given the heavy reliance of customers on credit and large-scale project financing, which remains difficult to obtain following the recent worldwide economic downturn and contraction in credit markets. Our efforts to increase awareness and adoption of our proton therapy systems may not be successful, which could negatively impact this business.

Our X-ray Products business sells products primarily to a small number of imaging system OEM customers who use our products in their medical diagnostic and industrial imaging systems. To succeed, we must provide x-ray tube and flat panel detector products that meet customer demands for lower cost, better product quality and superior technology and performance. If we are unable to continue to innovate our X-ray Products technology and anticipate our customers' demands in the areas of cost, quality, technology and performance, then our customers may choose to purchase from their internal manufacturing operations or from other independent tube or panel manufacturers (including the in-house operations of some of these customers), which would negatively impact this business.

We may be unable to accurately anticipate changes in our markets and the direction of technological innovation and demands of our customers, our competitors may develop improved products or processes, or the marketplace may conclude that the tasks our products were designed to do is no longer an element of a generally accepted diagnostic or treatment regimen. If this occurs, the market for our products may be adversely affected and they may become less useful or obsolete. Any development adversely affecting the markets for our products would force us to reduce production volumes or to discontinue manufacturing one or more of our products or product lines and would reduce our revenues and earnings.

### ***OUR SUCCESS DEPENDS ON THE SUCCESSFUL DEVELOPMENT, INTRODUCTION AND COMMERCIALIZATION OF NEW GENERATIONS OF PRODUCTS AND ENHANCEMENTS TO EXISTING PRODUCT LINES***

Our success depends on the successful development, introduction and commercialization of new generations of products, treatment systems and enhancements to and/or simplification of existing product lines. For example, in April 2010, we introduced TrueBeam, of a new line of linear accelerators designed for advanced radiotherapy and radiosurgery. Our Oncology Systems products are technologically complex and must keep pace with, among other things, those of our competitors. Our X-ray Products business must also continually develop improved and lower cost products. We are making significant investments in long-term growth initiatives, such as development of our SIP and Particle Therapy businesses, and expect that we will need more investment to develop and commercialize the products and technology for these businesses. Accordingly, many of our products may require significant planning, design, development and testing, as well as significant capital commitments, involvement of senior management and other investments on our part, which we may be unable to recover. Our timeline for the development of new products or enhancements may not be achieved and price and profitability targets may not prove feasible. Commercialization of new products or product lines may prove challenging, and we may be required to invest more time and money than expected to successfully introduce them. Once introduced, new products may adversely impact orders and sales of our existing products, or make them less desirable or even obsolete. Failure to introduce and commercialize new product lines, such as TrueBeam, without disrupting ongoing demand for our existing product lines, could adversely impact our revenues and operating results. Compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of new products or enhancements. A few of our research and development projects have been, and in the future may be, funded by government contracts, and changes in government priorities and our ability to attract similar funding may affect our overall research efforts.

Our ability to successfully develop and introduce new products, treatment systems and product enhancements and simplifications, and the revenues and costs associated with these efforts, are affected by our ability to:

properly identify customer needs;

prove feasibility of new products;

limit the time required from proof of feasibility to routine production;

comply with internal quality assurance systems and processes timely and efficiently;

limit the timing and cost of regulatory approvals;

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accurately predict and control costs associated with inventory overruns caused by phase-in of new products and phase-out of old products;

price our products competitively and profitably;

manufacture, deliver and install our products in sufficient volumes on time, and accurately predict and control costs associated with manufacturing, installation, warranty and maintenance of the products;

appropriately manage our supply chain;

manage customer acceptance and payment for products;

manage customer demands for retrofits of both new and old products; and

anticipate and compete successfully with competitors.

Additionally, the budgeting cycles of hospitals and clinics for capital equipment purchases are frequently fixed well in advance and have experienced pressure during the economic downturn, which may lengthen sales and ordering timeframes adversely affecting revenues associated with our products. We cannot be sure that we will be able to successfully develop, manufacture or introduce new products, treatment systems or enhancements, the roll-out of which involves compliance with complex quality assurance processes, including the Quality System Regulation ( QSR ) of the Food and Drug Administration ( FDA ). Failure to complete these processes timely and efficiently could result in delays that could affect our ability to attract and retain customers, or could cause customers to delay or cancel orders, causing our revenues and operating results to suffer.

New products generally take longer to install than well-established products. Because a portion of a product's revenue is generally tied to installation and acceptance of the product, our recognition of revenue associated with new products may be deferred longer than expected. While we will work to decrease the installation times for new products, such as we have done with installation times for our On-Board Imager® ( OBI ), these plans may not be successful or have a meaningful impact on reducing associated revenue recognition deferrals. Furthermore, even if these plans are successful, potential customers may not decide to upgrade their equipment, or customers may delay delivery of some of our more sophisticated products because of the longer preparation and renovation of treatment rooms required. As a result, our revenues and other financial results could be adversely affected.

***ROUGHLY HALF OF OUR REVENUES ARE INTERNATIONAL, AND ECONOMIC, POLITICAL AND OTHER RISKS ASSOCIATED WITH INTERNATIONAL SALES AND OPERATIONS COULD ADVERSELY AFFECT OUR SALES OR MAKE THEM LESS PREDICTABLE***

We conduct business globally. Our international revenues accounted for approximately 56% and 50% of revenues from continuing operations during the second quarter of fiscal years 2010 and 2009, respectively. As a result, we must provide significant service and support globally, and we have sales and service offices located in Europe, Asia, South America and Australia. We also have manufacturing and research operations in the United Kingdom, Germany, Switzerland, France, Finland, Canada and China. We have invested, and will continue to invest, substantial resources to meet the needs of our customers. We intend to continue to expand our presence in international markets, although we cannot be sure we will be able to compete successfully in the international markets, generate new business, or meet the service and support needs of our customers there. Accordingly, our future results could be harmed by a variety of factors, including:

the difficulties in enforcing agreements and collecting receivables through many foreign country's legal systems;

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the longer payment cycles associated with many foreign customers;

the possibility that foreign countries may impose additional taxes, tariffs or other restrictions on foreign trade;

the fact that international regions typically have a lower gross margin on our products and a longer period from shipment to revenue recognition that generally results in greater revenue recognition deferrals and higher backlog;

our ability to obtain export licenses and other required export or import licenses or approvals;

failure to comply with export laws and requirements which may result in civil or criminal penalties and restrictions on our ability to export our products, particularly our industrial linear accelerator products;

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failure to obtain proper business licenses or other documentation, or to otherwise comply with local laws and requirements regarding marketing, sales, service or any other business we conduct in a foreign jurisdiction, which may result in civil or criminal penalties and restrictions on our ability to conduct business in a foreign jurisdiction;

changes in the political, regulatory, safety or economic conditions in a country or region; and

the possibility that it may be more difficult to protect our intellectual property in foreign countries.

Historically, our international sales have had lower average selling prices and gross margins. Although our orders and sales fluctuate from period to period, in recent years our international regions have represented a larger share of our business. As a result, our overall rate of orders growth (measured in U.S. dollars) could slow down and overall revenues and gross margins may be negatively affected.

In addition, we generally retain cash from our international operations in our local subsidiaries. As of April 2, 2010, 91% of our cash and cash equivalents were held abroad. If these funds were repatriated to the United States, they could be subject to additional taxation and our overall tax rate and our results of operations could suffer.

Earnings from our international regions are generally taxed at rates lower than U.S. rates. Our effective tax rate is impacted by tax laws in both the United States and in the respective countries in which our international subsidiaries do business. A decrease in the percentage of our total earnings from international regions, or a change in the mix of international regions among particular tax jurisdictions, could increase our effective tax rate. Also, our current effective tax rate does not assume U.S. taxes on certain undistributed profits of certain foreign subsidiaries. These earnings could become subject to incremental foreign withholding or U.S. federal and state taxes should they either be deemed or actually remitted to the United States, or if tax laws change, in which case our financial results could be adversely affected. In addition, recent proposals would make significant changes to U.S. taxation of U.S.-based multinational corporations. Although we cannot predict whether or in what form Congress would enact any such proposals, legislation of this type could have an adverse impact on our effective tax rate and financial results.

***OUR RESULTS HAVE BEEN AND MAY CONTINUE TO BE HARMED BY THE WORLDWIDE ECONOMIC DOWNTURN***

Since fiscal year 2008, the global economy has been impacted by the sequential effects of the subprime lending crisis, the credit market crisis, collateral effects on the finance and banking industries, volatile currency exchange rates and energy costs, concerns about inflation, slower economic activity, decreased consumer confidence, reduced corporate profits and capital spending, adverse business conditions and liquidity concerns. These economic conditions worsened in fiscal year 2009. These conditions have shrunk capital equipment budgets, slowed decision-making, made financing for large equipment purchases more expensive and more time consuming, and made it difficult for our customers and our vendors to accurately forecast and plan future business activities. This, in turn, has caused and may continue to cause our customers to freeze or dramatically reduce purchases and capital project expenditures, and may result in consolidation of our customers. Even with economic recovery, it may take time for our customers to establish new budgets and return to normal purchasing patterns. These conditions may also disrupt supply if vendors consolidate or go out of business. In such a climate, it may continue to be more difficult for us to accurately forecast and plan our future business activities. We cannot predict when an economic recovery will occur, in general or specifically in the healthcare industry. Historically, our business has felt the effects of market trends later than other sectors in the healthcare industry, such as diagnostic radiology, and we may experience the effects of any economic recovery later than others in the healthcare industry. A continued weak or deteriorating healthcare market would inevitably adversely affect our business, financial conditions and results of operations. Also, while the economic downturn has primarily affected our business in North America, potential future economic turmoil, such as the banking and currency instability in Greece and other countries, may negatively affect our international business.

***THE RECENTLY ENACTED AFFORDABLE HEALTHCARE FOR AMERICA ACT INCLUDES PROVISIONS THAT MAY ADVERSELY AFFECT OUR BUSINESS AND RESULTS OF OPERATIONS, INCLUDING AN EXCISE TAX ON THE SALES OF MOST MEDICAL DEVICES***

On March 23, 2010, President Obama signed into law the Affordable Health Care for America Act. While we are continuing to evaluate this legislation and its potential impact on our business, it may adversely affect the demand for our products and services, and therefore our financial position and results of operations, possibly materially.

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Specifically, one of the components of the new law is a 2.3% excise tax on sales of most medical devices, which include our Oncology Systems products, starting in 2013. The total cost to the medical device industry could exceed \$20 billion over ten years. This tax may put increased pressure on medical device manufacturers and purchasers, and may lead our customers to reduce their orders for products we produce or to request that we reduce the prices we charge for our products in order to off-set the tax. Other elements of this new legislation, including comparative effectiveness research, an independent payment advisory board, payment system reforms (including shared savings pilots) and other provisions, could meaningfully change the way healthcare is developed and delivered, and may materially impact numerous aspects of our business, including the demand and availability of our products, the reimbursement available for our products from governmental and third-party payors, and reduced medical procedure volumes.

Various healthcare reform proposals have also emerged at the state level, and we are unable to predict which, if any of these proposals will be enacted. We believe that the uncertainty created by the prospects of healthcare reform in the United States has complicated our customers decision-making process and impacted our Oncology Systems business, and we expect that this uncertainty will persist until there is greater clarity on how the Affordable Health Care for America Act and state proposals will affect healthcare providers. We are unable to predict what effect ongoing uncertainty surrounding these matters will have on our customer s purchasing decisions. However, an expansion in government s role in the U.S. healthcare industry may adversely affect our business, possibly materially.

***CHANGES TO RADIATION ONCOLOGY REIMBURSEMENTS MAY AFFECT DEMAND FOR OUR PRODUCTS***

Sales of our healthcare products indirectly depend on whether adequate reimbursement is available to our customers from a variety of sources, such as government healthcare insurance programs, including the Medicare and Medicaid programs; private insurance plans; health maintenance organizations and preferred provider organizations. Once Medicare has made a decision to provide reimbursement for a given treatment, these reimbursement rates are generally reviewed and adjusted by Medicare annually. Private third-party payors, although independent from Medicare, sometimes use portions of Medicare reimbursement policies and payment amounts in making their own reimbursement decisions. As a result, decisions by the U.S. Centers for Medicare and Medicaid Services ( CMS ) to reimburse for a treatment, or changes to Medicare s reimbursement policies or reductions in payment amounts with respect to a treatment sometimes extend to third-party payor reimbursement policies and amounts for that treatment. We have seen our customers decision-making process complicated by the uncertainty surrounding Medicare reimbursement rates for radiotherapy and radiosurgery at free-standing clinics in the United States and for physician reimbursement for radiation oncology. We believe that this confusion and uncertainty been a major factor impacting our net orders since mid-2009, particularly from free-standing radiotherapy clinics. From time to time, CMS and third party payors may review and modify the factors upon which they rely to determine appropriate levels of reimbursement for cancer treatments. For example, CMS and third-party payors have begun to focus on the comparative effectiveness of radiation therapy versus other methods of cancer treatment, and could modify reimbursement rates based on the results of comparative effectiveness studies. If comparative effectiveness studies are not available, or if available studies show that other cancer treatments are more effective than radiotherapy or radiosurgery, reimbursement rates for radiotherapy or radiosurgery could be reduced. Any significant cuts in reimbursement rates for radiotherapy, radiosurgery, proton therapy or brachytherapy, or concerns or proposals regarding further cuts, could further increase uncertainty, influence our customers decisions, reduce demand for our products, cause customers to cancel orders and have a material adverse effect on our revenues and stock price.

In general, third-party payors in the United States are increasingly cost-conscious, and we cannot be sure that they will reimburse our customers at levels sufficient to enable us to achieve or maintain sales and price levels for our products in this market. Without adequate support from third-party payors, the market for our products may be limited. There is no uniform policy on reimbursement among third-party payors, nor can we be sure that procedures using our products will qualify for reimbursement from third-party payors. Likewise, foreign governments also have their own healthcare reimbursement systems and we cannot be sure that adequate reimbursement will be made available with respect to our products under any foreign reimbursement system.

***OUR RESULTS MAY BE IMPACTED BY CHANGES IN FOREIGN CURRENCY EXCHANGE RATES***

Because our business is global and payments are generally made in local currency, fluctuations in foreign currency exchange rates can impact our results by affecting product demand or our expenses and/or the profitability in U.S. dollars of products and services that we provide in foreign markets.

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While we use hedging strategies to help offset the effect of fluctuations in foreign currency exchange rates, the protection these strategies provide are affected by the timing of transactions, and the effectiveness of those strategies, the number of transactions that are hedged, forecast volatility and the extent to which exchange rates have changed. If our hedging strategies do not offset these fluctuations, our revenues and other operating results may be harmed. In addition, movement in foreign currency exchange rates could impact our financial results positively or negatively in one period and not another, making it more difficult to compare our financial results from period to period.

In addition, long-term movements in foreign currency exchange rates can also affect the competitiveness of our products in the local currencies of our international customers. Even though our international sales are mostly in local currencies, our cost structure is weighted towards the U.S. dollar, and some of our competitors may have cost structures based in other currencies. The volatility of the U.S. dollar that we have experienced over the last several years has affected the competitiveness of our pricing against our foreign competitors, either helping or hindering our international order and revenue growth, thereby affecting our overall financial performance and results. Changes in monetary or other policies here and abroad, including as a result of the recent economic downturn or in reaction thereto, or in the United States as a result of a change in the U.S. laws or regulations that will likely affect foreign currency exchange rates.

***WE FACE SIGNIFICANT COSTS IN ORDER TO COMPLY WITH LAWS AND REGULATIONS APPLICABLE TO THE MANUFACTURE AND DISTRIBUTION OF OUR PRODUCTS, AND FAILURE OR DELAYS IN OBTAINING REGULATORY CLEARANCES OR APPROVALS, OR FAILURE TO COMPLY WITH APPLICABLE LAWS AND REGULATIONS COULD PREVENT US FROM DISTRIBUTING OUR PRODUCTS OR RESULT IN SIGNIFICANT PENALTIES***

Our products and those of OEMs that incorporate our products are subject to extensive and rigorous government regulation, both in the United States and in foreign countries. Compliance with these laws and regulations is expensive and time-consuming, and failure to comply with these laws and regulations could adversely affect our business.

*Marketing a medical device in the United States.* In the United States, as a manufacturer and seller of medical devices and devices emitting radiation or utilizing radioactive by-product material, we and some of our suppliers and distributors are subject to extensive regulation by federal governmental authorities, such as the FDA, Nuclear Regulatory Commission ( NRC ) and state and local regulatory agencies, such as the State of California, to ensure the devices are safe and effective and comply with laws governing products which emit, produce or control radiation. Similar international regulations apply overseas. These regulations govern, among other things, the design, development, testing, manufacturing, packaging, labeling, distribution, import/export, sale and marketing and disposal of our products.

Unless an exception applies, the FDA requires that the manufacturer of a new medical device or a new indication for use of, or other significant change in, an existing medical device obtain either 510(k) pre-market notification clearance or pre-market approval ( PMA ) before we can market or sell those products in the United States. Modifications or enhancements to a product that could significantly affect its safety or effectiveness, or that would constitute a major change in the intended use of the device, technology, materials, labeling, packaging, or manufacturing process may also require a new 510(k) clearance. Obtaining clearances or approvals is time-consuming, expensive and uncertain. We may not be able to obtain the necessary clearances or approvals or may be unduly delayed in doing so, which could harm our business. Furthermore, even if we are granted regulatory clearances or approvals, they may include significant limitations on the indicated uses of the product, which may limit the market for those products. If we were unable to obtain required FDA clearance or approval for a product or unduly delayed in doing so, or the uses of that product were limited, our business would suffer. In the past, in the United States, our devices have generally been subject to 510(k) clearance or exempt from 510(k) clearance. The 510(k) clearance process is generally less time-consuming, expensive and uncertain than the PMA process. However, there are some in the regulatory field who believe that certain medical devices should be required to use the PMA approval process, or a special more time-consuming 510(k) clearance process, rather than the current 510(k) clearance process. If we were required to use either of these lengthy processes for future products or product modifications, it could delay or prevent release of the proposed products or modifications, which could harm our business.

*Marketing a medical device internationally.* In order for us to market our products internationally, we must obtain clearances or approvals for products and product modifications. These processes (including for example in the EEA, China, Japan and Canada) can be time consuming, expensive, and uncertain, which can delay our ability to market products in those countries. If we do not obtain the clearance or approvals on one or more of our products, or are unduly delayed in doing so, or if a clearance or approval includes significant limitations on the indicated uses of the product, the market for the affected products would be negatively impacted.

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Within the EEA, we must affix a CE mark, a European marking of conformity that indicates that a product meets the relevant regulatory requirements and, when used as intended, works properly and is acceptably safe. This conformity to the applicable directives is done through self-declaration and may be verified by an independent certification body, called a Notified Body. Once clearance is obtained and the CE mark is affixed to the device, the Notified Body will regularly audit us to ensure that we remain in compliance with the applicable European laws or directives. CE marking demonstrates that our products comply with the laws and regulations required by the EEA countries to allow free movement of trade within the EEA countries. If we cannot support our performance claims and demonstrate compliance with the applicable European laws and directives, we lose our CE mark, which would prevent us from selling our products within the EEA. Significant revisions to some of the applicable regulations governing requirements for medical devices in the EEA went into effect in March 2010. These revisions have introduced additional uncertainty into the marketing authorization process for medical devices in Europe. Until medical device manufacturers and European regulatory agencies, including Notified Bodies and competent authorities, have greater experience with interpreting and applying the revised regulations, we may be subject to risks associated with additional testing, modification, certification or amendment of our existing market authorizations, or we may be required to modify installed products in order to comply with the official interpretations of these revised regulations.

*Quality systems, audits and failure to comply.* Our manufacturing operations are required to comply with the FDA's QSR, and other federal and state regulations for medical devices and radiation emitting products that address a company's responsibility for complying with the quality systems regulations, which include the requirements for current good manufacturing practices. The FDA makes announced and unannounced inspections of medical device manufacturers to determine compliance with QSR and in connection with these inspections has issued, and in the future may issue, reports, known as Form FDA 483 reports (listing instances where the manufacturer has failed to comply with applicable regulations and/or procedures), or Warning Letters citing failure to comply with applicable regulations or procedures. If a Warning Letter were issued, we would be required to take prompt corrective action to come into compliance. Failure to respond timely to a Warning Letter or other notice of noncompliance and to come into compliance could result in the FDA bringing enforcement action against us, which could include the total shutdown of our production facilities and criminal and civil fines. Additionally, if a Warning Letter were issued, customers could delay purchasing decisions or cancel orders, and we could face increased pressure from our competitors, who could use the Warning Letter against us in competitive sales situations, either of which could adversely affect our reputation, business and stock price.

In addition, we are required to timely file various reports with the FDA and other international regulatory authorities, including reports required by the medical device reporting regulations, and similar international adverse event reporting regulations, that require that we report to regulatory authorities if our devices may have caused or contributed to a death or serious injury or malfunctioned in a way that would likely cause or contribute to a death or serious injury if the malfunction were to recur. If these reports are not filed timely, regulators may impose sanctions and sales of our products may suffer, and we may be subject to product liability or regulatory enforcement actions, all of which could harm our business.

If we initiate a correction or removal of a device to reduce a risk to health posed by the device, we would be required to submit a Corrections and Removals report to the FDA and in many cases, similar reports to other regulatory agencies. This report could be classified by the FDA as a device recall which could lead to increased scrutiny by the FDA and other international regulatory agencies regarding the quality and safety of our devices.

Our medical devices utilizing radioactive material are subject to the NRC clearance and approval requirements, and the manufacture and sale of these products are subject to extensive international, federal and state regulation that varies from state to state and among countries or regions. Our manufacture, distribution, installation and service of medical devices utilizing radioactive material or emitting radiation also requires us to obtain a number of licenses and certifications for these devices and materials. Service of these products must also be in accordance with a specific radioactive materials license. Obtaining licenses and certifications may be time consuming, expensive and uncertain. In addition, we are subject to a variety of environmental laws regulating our manufacturing operations and the handling, storage, transport and disposal of hazardous materials, and which impose liability for the cleanup of any contamination from these materials. In particular, the handling and disposal of radioactive materials resulting from the manufacture, use or disposal of our products may impose significant costs and requirements. Disposal sites for the lawful disposal of materials generated by the manufacture, use or decommissioning of our products may no longer accept these materials in the future, or may accept them on unfavorable terms.



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The FDA and the Federal Trade Commission ( *FTC* ) also regulate advertising and promotion of our products to ensure that the claims we make are consistent with our regulatory clearances, that there are scientific data to substantiate the claims and that our advertising is neither false nor misleading. If the FDA or *FTC* determines that any of our advertising or promotional claims are not permissible, we may be subject to enforcement actions and may be required to revise our promotional claims or make other corrections or restitutions.

If we or any of our suppliers, distributors or customers fail to comply with FDA, *FTC* and other applicable U.S. and foreign country regulatory requirements or are perceived to potentially have failed to comply, we may face:

adverse publicity affecting both us and our customers;

increased pressures from our competitors;

investigations by governmental authorities or Warning Letters;

fines, injunctions, and civil penalties;

partial suspensions or total shutdown of production facilities, or the imposition of operating restrictions;

increased difficulty in obtaining required FDA clearances or approvals, or the equivalent approvals in foreign countries;

losses of clearances or approvals already granted;

seizures or recalls of our products or those of our customers;

delays in purchasing decisions by customers or cancellation of existing orders;

the inability to sell our products, or, where we have failed to comply with foreign regulations, to import our products to such countries;

difficulty in obtaining product liability or operating insurance at a reasonable cost, or at all; and

criminal prosecutions.

*Other applicable regulations.* As a participant in the healthcare industry, we are also subject to extensive laws and regulations protecting the privacy and integrity of patient medical information, including the Health Insurance Portability and Accountability Act of 1996 ( *HIPAA* ) and similar laws and regulations in foreign countries covering data privacy and other protection of health and employee information, fraud and abuse laws and regulations, including, physician self-referral prohibitions, anti-kickback laws and false claims laws. From time to time, these laws and regulations may be revised or interpreted in ways that could make it more difficult for our customers to conduct their businesses, such as recent proposed revisions to the laws prohibiting physician self-referrals, and such revisions could have an adverse effect on the demand for our products, and therefore our business and results of operations. We also must comply with numerous federal, state and local laws of more general applicability relating to such matters as safe working conditions, manufacturing practices and fire hazard control.

## Edgar Filing: VARIAN MEDICAL SYSTEMS INC - Form 10-Q

The laws and regulations and their enforcement are constantly undergoing change, and we cannot predict what effect, if any, changes to these laws and regulations may have on our business. There has been a trend in recent years, both in the United States and internationally, toward more stringent regulation and enforcement of requirements applicable to medical device manufacturers and requirements regarding protection and confidentiality of personal data.

Government regulation also may cause considerable delay or even prevent the marketing and full commercialization of future products or services that we may develop, and/or may impose costly requirements on our business. Insurance coverage is not commercially available for violations of law, including the fines, penalties or investigatory costs that may flow to us as the consequence of regulatory violations; consequently, we do not have insurance that would cover this type of liability.

***COMPLIANCE WITH FOREIGN LAWS AND REGULATIONS APPLICABLE TO THE MANUFACTURE AND DISTRIBUTION OF OUR PRODUCTS MAY BE COSTLY, AND FAILURE TO COMPLY MAY RESULT IN PENALTIES***

Regulatory requirements affecting our operations and sales outside the United States vary from country to country, often differing significantly from those in the United States. In general, outside the United States, our products are regulated as

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medical devices by foreign governmental agencies similar to the FDA. We are also subject to laws and regulations that apply to manufacturers of radiation emitting devices and products utilizing radioactive materials, as well as laws and regulations of general applicability relating to matters such as environmental protection, safe working conditions, manufacturing practices and other matters. These are often comparable to, if not more stringent than, the equivalent regulations in the United States. Sales overseas are also affected by regulation of matters such as product standards, packaging, labeling, environmental and product recycling requirements, import and export restrictions, tariffs, duties and taxes. In some countries, we rely on our foreign distributors to assist us in complying with foreign regulatory requirements, and we cannot be sure that they will always do so. We may be required to incur significant time and expense in obtaining and maintaining regulatory approvals. Delays in receipt of or failure to receive regulatory approvals, the loss of previously obtained approvals or failure to comply with existing or future regulatory requirements could restrict or prevent us from doing business in a country or subject us to a variety of enforcement actions and civil or criminal penalties, which would adversely affect our business.

***WE ARE SUBJECT TO FEDERAL, STATE AND FOREIGN LAWS GOVERNING OUR BUSINESS PRACTICES WHICH, IF VIOLATED, COULD RESULT IN SUBSTANTIAL PENALTIES. ADDITIONALLY, CHALLENGES TO OR INVESTIGATION INTO OUR PRACTICES COULD CAUSE ADVERSE PUBLICITY AND BE COSTLY TO RESPOND TO AND THUS COULD HARM OUR BUSINESS***

The Medicare and Medicaid anti-kickback laws, and several similar state laws, prohibit payments or other remuneration that is intended to induce hospitals, physicians or others either to refer patients or to purchase, lease or order, or arrange for or recommend the purchase, lease or order of healthcare products or services for which payment may be made under federal and state healthcare programs, such as Medicare and Medicaid. These laws affect our sales, marketing and other promotional activities by limiting the kinds of financial arrangements we may have with hospitals, physicians or other potential purchasers of our products. They particularly impact how we structure our sales offerings, including discount practices, customer support, education and training programs, physician consulting, research grants and other service arrangements. These laws are broadly written, and it is often difficult to determine precisely how these laws will be applied to specific circumstances.

Federal and state false claims laws generally prohibit knowingly presenting, or causing to be presented, claims for payment from Medicare, Medicaid or other third-party payors that are false or fraudulent, or for items or services that were not provided as claimed. Although we do not submit claims directly to payors, manufacturers can be held liable under these laws if they are deemed to cause the submission of false or fraudulent claims by providing inaccurate billing or coding information to customers, or through certain other activities, including promoting products for uses not approved or cleared by the FDA, which is called off-label promotion. Violating anti-kickback and false claims laws can result in civil and criminal penalties, which can be substantial, and potential exclusion from healthcare programs for noncompliance. Even an unsuccessful challenge or investigation into our practices could cause adverse publicity, and be costly to defend, and thus could harm our business and results of operations. Additionally, several proposals and bills are being considered at both the state and federal levels expanding anti-kickback laws to require, among other things, extensive tracking, maintenance of data bases regarding and disclosures of relationships and payments to physicians and healthcare providers. If these proposals or bills were to become law, the implementation of the necessary infrastructure to comply with them could be quite costly.

We are subject to similar laws in foreign countries where we conduct business. For example, within the European Union ( EU ), the control of unlawful marketing activities is a matter of national law in each of the member states of the EU. The member states of the EU closely monitor perceived unlawful marketing activity by companies. We could face civil, criminal and administrative sanctions if any member state determines that we have breached our obligations under its national laws. Industry associations also closely monitor the activities of member companies. If these organizations or authorities name us as having breached our obligations under their regulations, rules or standards, our reputation would suffer and our business and financial condition could be adversely affected.

We are also subject to the U.S. Foreign Corrupt Practices Act, antitrust and anti-competition laws, and similar laws in foreign countries, any violation of which could create a substantial liability for us and also cause a loss of reputation in the market. From time to time, we may face audits or investigations by one or more domestic or foreign government agencies, compliance with which could be costly and time-consuming, and could divert our management and key personnel from our business operations. An adverse outcome under any such investigation or audit could subject us to fines or other penalties, which could adversely affect our business and financial results.

As we enter new businesses or pursue new business opportunities, we may become subject to laws, rules and regulations, such as FDA regulations applicable to clinical trials. Becoming familiar with and implementing the infrastructure necessary to comply with these laws, rules and regulations could be quite costly. In addition, failure to comply with these laws, rules and regulations could delay the introduction of new products and could adversely affect our business.



**Table of Contents*****PRODUCT DEFECTS OR MISUSE MAY RESULT IN MATERIAL PRODUCT LIABILITY OR PROFESSIONAL ERRORS AND OMISSIONS CLAIMS, INVESTIGATION BY REGULATORY AUTHORITIES OR PRODUCT RECALLS THAT COULD HARM FUTURE REVENUES AND REQUIRE US TO PAY MATERIAL UNINSURED CLAIMS***

Our business exposes us to potential product liability claims that are inherent in the manufacture, sale, installation, servicing and support of medical devices and other devices that deliver radiation. Because our products are involved in the intentional delivery of radiation to the human body, other situations where people may come in contact with radiation (for example, when our SIP products are being used to scan cargo), the collection and storage of patient treatment data for medical analysis and treatment delivery, the planning of radiation treatment and diagnostic imaging of the human body, and the diagnosing of medical problems, the possibility for significant injury and/or death exists. Our medical products operate within our customers' facilities and network systems, and under quality assurance procedures established by the facility that ultimately result in the delivery of radiation to patients. Human and other errors or accidents may arise from the fact that our products operate in complex environments with products from other vendors, where interoperability or data sharing protocol may not be optimized even though the equipment or system operate according to specifications. As a result, we may face substantial liability to patients, our customers and others for damages resulting from the faulty, or allegedly faulty, design, manufacture, installation, servicing, support, testing or interoperability of our products, or their misuse or failure, as well as liability related to the loss or misuse of private patient data. We may also be subject to claims for property damages or economic loss related to or resulting from any errors or defects in our products, or installation, servicing and support of our products. With any accident or mistreatment, we could be subject to legal costs, adverse publicity and damage to our reputation, whether or not our products or services were a factor. Adverse publicity could adversely impact our business by negatively affecting the reputation of radiation therapy in general, causing patients to question the efficacy of radiation therapy as a viable treatment for cancer and seek other methods of treatment. In addition, publicity regarding any accidents or mistreatments, even ones that do not involve our products, could cause patients to be less receptive to radiotherapy treatments or result in additional regulation of radiation therapy, medical devices or the healthcare industry in general. Increased regulatory activities could adversely affect our ability to promote, manufacture and sell our products, and therefore negatively impact our business and results of operations.

In addition, if a product we designed or manufactured were defective (whether due to design, labeling or manufacturing defects, improper use of the product or other reasons), we may be required to recall the product and notify regulatory authorities. The adverse publicity resulting from a recall could damage our reputation and cause customers to review and potentially terminate their relationships with us. A product recall could consume management time and have an adverse financial impact on our business, including incurring substantial costs, lost revenues and loss accruals under GAAP that may cause our quarterly results to fluctuate.

We maintain limited product liability insurance coverage and currently self-insure professional liability/errors and omissions liability. The product liability insurance policies that we maintain are expensive and have high deductible amounts and self-insured retentions. The insurance coverage we have obtained may prove to be inadequate, and future policies may not be available on acceptable terms or in sufficient amounts, if at all. A material claim successfully brought against us relating to a self-insured liability or a liability that is in excess of our insurance coverage, or for which insurance coverage is denied or limited would require us to pay damage amounts that could be substantial and have a material adverse effect on our financial position and results of operation.

***WE COMPETE IN HIGHLY COMPETITIVE MARKETS, AND WE MAY LOSE MARKET SHARE TO COMPANIES WITH GREATER RESOURCES OR THE ABILITY TO DEVELOP MORE EFFECTIVE TECHNOLOGIES, OR WE COULD BE FORCED TO REDUCE OUR PRICES***

Rapidly evolving technology, intense competition and pricing pressure characterize the markets for radiation therapy equipment and software. Some of our competitors have greater financial, marketing and other resources than we have. Also, we believe that new competitors will enter our markets, as we have encountered new competitors as we enter new markets such as stereotactic radiosurgery, VMAT and proton therapy. To compete successfully, we must provide technically superior, clinically proven products that deliver more precise, cost-effective, high quality clinical outcomes, together in a complete package of products and services, and to do so ahead of our competitors. As our Oncology Systems products are generally sold on a basis of total value to the customer, our business may suffer when purchase decisions are based solely upon price, which can happen if hospitals and clinics give purchasing decision authority to group purchasing organizations. In addition,

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additional competitors may delay customer purchasing decisions as customers evaluate the products of these competitors along with ours, potentially extending our sales cycle and adversely affect our net orders.

In x-ray imaging components and subsystems, we often compete with companies that have greater financial, marketing and other resources than we have. Some of the major diagnostic imaging systems companies, which are the primary OEM customers for our x-ray components, also manufacture x-ray components, including x-ray tubes, for use in their own imaging systems products. We must compete with these in-house manufacturing operations for business from their affiliated companies. In addition, we compete against other stand-alone, independent x-ray tube manufacturers who compete with us for both the OEM business of major diagnostic imaging equipment manufacturers and the independent servicing business for x-ray tubes. The market for flat panel detectors is also very competitive. As a result, we must have a competitive advantage in one or more significant areas, which may include lower product cost, better product quality and/or superior technology and/or performance.

In our SIP business, we compete with other OEM suppliers, primarily outside of the United States. The market for our SIP products used for nondestructive testing in industrial applications is small and highly fractured.

The market for proton therapy products is still developing and is characterized by rapidly evolving technology, high competition and pricing pressure. Our ability to compete successfully depends, in part, on our ability to complete the development of our commercial proton therapy system, lower our product costs, develop and provide technically superior, clinically proven products that deliver more precise, cost-effective, high quality clinical outcomes, including integration of IGRT technologies such as OBI.

In each of our business segments, existing competitors' actions and new entrants may adversely affect our ability to compete. These competitors could develop technologies and products that are more effective than those we currently use or produce or that could render our products obsolete or noncompetitive. In addition, the timing of our competitors' introduction of products into the market could affect the market acceptance and market share of our products. Some competitors offer specialized products that provide, or may be perceived by customers to provide, a marketing advantage over our mainstream cancer treatment products. Also, some of our competitors may not be subject to the same standards, regulatory and/or other legal requirements that we are, and therefore, they could have a competitive advantage in developing, manufacturing and marketing products and services. Any inability to develop, gain regulatory approval for and supply commercial quantities of competitive products to the market as quickly and effectively as our competitors could limit market acceptance of our products and reduce our sales. In addition, some of our smaller competitors could be acquired by larger companies that have greater financial strength, which could enable them to compete more aggressively. Our competitors could also acquire some of our suppliers or distributors, which could disrupt these supply or distribution arrangements and result in less predictable and reduced revenues in our businesses. Any of these competitive factors could negatively affect our pricing, sales, revenues, market share and gross margins and our ability to maintain or increase our operating margins.

### ***OPEN ARCHITECTURE IS BECOMING INCREASINGLY IMPORTANT, AND SALES OF OUR PRODUCTS COULD FALL IF WE FAIL TO ACHIEVE THIS***

As radiation therapy becomes more and more complex, interoperability and compatibility of the various products used in treating patients becomes more important. Our linear accelerators, treatment simulators, treatment verification products, treatment planning and information management software products are designed to interoperate with one another, and, wherever possible, to use standard published protocols for communication with other widely used radiation oncology products manufactured by other companies. In the event proper communication with particular third party products cannot be achieved using standard published protocols, we may need to develop individual interfaces so that our products communicate correctly. Obtaining and maintaining this interoperability and compatibility can be costly and time-consuming. When other companies modify the design or functionality of their products, this may affect their compatibility with our products. When we implement design improvements to our products, customers may be reluctant to adopt our new technology due to interoperability issues. For example, a clinic may be unwilling to implement one of our new technologies because its third-party software does not yet communicate correctly with our new product. Our ability to obtain compatibility with products of other companies may depend on our ability to obtain adequate information from them regarding their products. In many cases, these third parties are our competitors and may schedule their product changes and delay their release of relevant information to us to place us at a competitive disadvantage. When we modify our products to make them interoperable or compatible with third-party products, we may be required to obtain additional regulatory clearances. This process is costly and could result in delay in our ability to release our products for commercial use. It is also possible that, despite our best efforts, we may not be able to make our products interoperable or compatible with widely used third-party products or may only be able to do so at a prohibitive expense, making our products less attractive or more costly to our customers.

**Table of Contents*****PROTECTING OUR INTELLECTUAL PROPERTY CAN BE COSTLY, AND OUR COMPETITIVE POSITION WOULD BE HARMED IF WE ARE NOT ABLE TO DO SO***

We file applications as appropriate for patents covering new products and manufacturing processes. We cannot be sure, however, that our current patents, the claims allowed under our current patents, or patents for technologies licensed to us will be sufficiently broad to protect our technology position against competitors. Issued patents owned by, or licensed to, us may be challenged, invalidated or circumvented, or the rights granted under the patents may not provide us with competitive advantages. We also cannot be sure that patents will be issued from any of our pending or future patent applications. Asserting our patent rights against others in litigation or other legal proceedings is costly and diverts managerial resources. An unfavorable outcome in any such litigation or proceeding could harm us. In addition, we may not be able to detect patent infringement by others or may lose our competitive position in the market before we are able to do so.

We also rely on a combination of copyright, trade secret and other laws, and contractual restrictions on disclosure, copying and transferring title (including confidentiality agreements with vendors, strategic partners, co-developers, employees, consultants and other third parties), to protect our proprietary rights. These protections may prove inadequate, since agreements may still be breached and we may not have adequate remedies for a breach, and our trade secrets may otherwise become known to or be independently developed by others. We have trademarks, both registered and unregistered, that are maintained and enforced to provide customer recognition for our products in the marketplace, but unauthorized third parties may still use them. We also have agreements with third parties that license to us certain patented or proprietary technologies. If we were to lose the rights to license these technologies, or our costs to license these technologies were to materially increase, our business would suffer.

***THIRD PARTIES MAY CLAIM WE ARE INFRINGING THEIR INTELLECTUAL PROPERTY, AND WE COULD SUFFER SIGNIFICANT LITIGATION OR LICENSING EXPENSES OR BE PREVENTED FROM SELLING OUR PRODUCTS***

The industries in which we compete are characterized by a substantial amount of litigation over patent and other intellectual property rights. Our competitors, like companies in many high technology businesses, continually review other companies' products for possible conflicts with their own intellectual property rights. Determining whether a product infringes a third party's intellectual property rights involves complex legal and factual issues, and the outcome of this type of litigation is often uncertain. Third parties may claim that we are infringing their intellectual property rights, and we may be found to infringe those intellectual property rights. We may not be aware of intellectual property rights of others that relate to our products, services or technologies. From time to time, we have received notices from third parties asserting infringement and we have been subject to lawsuits alleging infringement of third-party patent or other intellectual property rights. Any dispute regarding patents or other intellectual property could be costly and time-consuming, and could divert our management and key personnel from our business operations, and we may not prevail in a dispute. We do not maintain insurance for intellectual property infringement, so if we are unsuccessful in defending an infringement claim, we may be subject to significant damages or injunctions against development and sale of our products, or may be required to enter into costly royalty or license agreements. Required licenses may not be made available to us on acceptable terms or at all.

***THE LOSS OF A SUPPLIER OR ANY INABILITY TO OBTAIN SUPPLIES OF IMPORTANT COMPONENTS COULD RESTRICT OUR ABILITY TO MANUFACTURE PRODUCTS, CAUSE DELAYS IN OUR ABILITY TO DELIVER PRODUCTS, OR SIGNIFICANTLY INCREASE OUR COSTS***

We obtain some of the components included in our products from a limited group of suppliers or from a single-source supplier, such as the radioactive sources for high-dose afterloaders, klystrons for linear accelerators, array sensors for use in our imaging panels, cesium iodide coatings for the arrays, and specialized integrated circuits, x-ray tube targets, housings, glassframes and various other x-ray tube components. If we lose any of these suppliers or if their operations were substantially interrupted, we would be required to obtain and qualify one or more replacement suppliers, which may then also require us to redesign or modify our products to incorporate new parts and/or further require us to obtain clearance, qualification or certification of such product by the FDA or other applicable regulatory approvals in other countries. Events like these could significantly increase costs for the affected product and likely cause material delays in delivery of that and other related products. We have limited insurance to protect against business interruption loss, although our coverage may not be adequate or continue to remain available on acceptable terms, if at all. Additionally, some of these suppliers, including our single-source suppliers, supply components for certain of our rapidly growing product lines. Manufacturing capacity limitations of any of these suppliers or other inability of these suppliers to meet increasing demand could adversely affect us, resulting in curtailed growth opportunities for any of our product lines. Shortage of, and greater demand for,

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components and subassemblies could also increase manufacturing costs by increasing prices. Disruptions or loss of any of our limited- or sole-source components or subassemblies or the capacity limitations of the suppliers for these components or subassemblies, including the ones referenced above, could adversely affect our business and financial results and could damage our customer relationships.

### ***A SHORTAGE OF RAW MATERIALS COULD RESTRICT OUR ABILITY TO MANUFACTURE PRODUCTS, CAUSE DELAYS, OR SIGNIFICANTLY INCREASE OUR COST OF GOODS***

We rely upon the supplies of certain raw materials such as tungsten, lead and copper for Oncology Systems and SIP; copper, lead, tungsten, rhenium, molybdenum zirconium, and various high grades of steel alloy for X-ray Products, and high-grade steel and high-grade copper for the Varian Particle Therapy business. Demand for these raw materials both within the United States and from foreign countries, such as China, has increased over the last few years, resulting in limited supplies and higher prices. Worldwide demand, availability and pricing of these raw materials have been volatile, and we expect that availability and pricing will continue to fluctuate in the future. If supplies are restricted and prices increase, this could constrain our manufacturing of affected products, reduce our profit margins or otherwise adversely affect our business.

### ***CONSOLIDATION AMONG OUR ONCOLOGY SYSTEMS CUSTOMERS COULD ADVERSELY AFFECT OUR SALES OF ONCOLOGY PRODUCTS***

We have seen and may continue to see some consolidation among our customers in our Oncology Systems business, as hospitals and clinics combine through mergers and acquisitions, and as they join group purchasing organizations or affiliated enterprises. As customers consolidate, the volume of product sales to these customers might decrease. Alternatively, order size may increase as what were previously more than one customer combine orders as one entity. As a result, the purchasing cycle for our Oncology Systems products could lengthen, as orders increase in size and require more customer approvals. Both increased order size and extended purchasing cycles could cause our net orders for these products to be more volatile and less predictable. In addition, group purchasing organizations often focus on pricing as the determinant in making purchase decisions. A reduction in net orders could affect the level of future revenues, which would adversely affect our operating results, financial condition, and the price of VMS common stock.

### ***WE SELL OUR X-RAY TUBES TO A LIMITED NUMBER OF OEM CUSTOMERS, MANY OF WHICH ARE ALSO OUR COMPETITORS, AND A REDUCTION IN BUSINESS BY ONE OR MORE OF THESE CUSTOMERS OR CONSOLIDATION OF CUSTOMERS COULD REDUCE OUR SALES***

There has been a consolidation of diagnostic imaging systems manufacturers over the past few years, including the consolidation of these customers into companies that already manufacture x-ray tubes. If this continues, we could experience less predictable and reduced sales of our x-ray tube products. In addition, the recent economic downturn has made it difficult for our OEM customers to accurately forecast and plan future business activities, and we saw our x-ray business impacted in fiscal year 2009 by inventory reduction efforts at some of these customers. The market for new X-ray imaging equipment has been weak, and certain product lines, such as dental and veterinary, were particularly hard hit in the recession. If the markets for our customers' products do not recover but instead further deteriorate, our X-ray Products business may be adversely affected. In recent years, we have also seen dramatic reductions in Medicare reimbursements for diagnostic radiology. We believe reductions in these Medicare reimbursement rates have reduced demand for medical x-ray imaging equipment, such as CT scanners, which have negatively impacted demand for our x-ray tube products. Also, because we sell our x-ray products to a limited number of OEM customers and many of them are also our competitors with in-house x-ray tube manufacturing operations, we could experience the loss of, or reduction in purchasing volume by, one or more of these customers if they lower external sourcing costs. Such a loss or reduction could have a material adverse effect on our X-ray Products business.

### ***ORDERS FOR OUR SECURITY AND INSPECTION PRODUCTS COULD BE UNPREDICTABLE***

Our SIP business designs, manufactures, sells and services Linatron x-ray accelerators, imaging processing software and image detection products for security and inspection, such as cargo screening at ports and borders and nondestructive examination for a variety of applications. We generally sell SIP products to OEMs who incorporate our products into their inspection systems, which are then sold to customs and other government agencies, as well as to commercial organizations in the casting, power, aerospace, chemical, petro-chemical and automotive industries. We believe growth in the SIP business will be driven by security cargo screening and border protection needs, as well as by the needs of customs agencies to verify shipments for assessing duties and taxes. However, use of linear accelerator and imaging technology in security cargo screening and border protection is in its early stages. Orders for our SIP products have been and may continue to be





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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. Because it is difficult to predict our OEM customer delivery and acceptance schedules, the actual timing of sales and revenue recognition will vary significantly.

In addition, our SIP business is heavily influenced by U.S. and foreign governmental policies on national and homeland security, border protection and customs revenue activities, which depend upon government budgets and appropriations that are subject to political changes. We have seen customers freeze or dramatically reduce purchases and capital project expenditures, or act cautiously as governments around the world wrestle with spending priorities. As a result, this business is subject to unpredictability in the timing of orders, sales and revenue that could cause volatility in our revenues and earnings, and therefore the price of VMS common stock.

***IF WE ARE UNABLE TO PROVIDE THE SIGNIFICANT EDUCATION AND TRAINING REQUIRED FOR THE HEALTHCARE MARKET TO ACCEPT OUR PRODUCTS, OUR BUSINESS WILL SUFFER***

In order to achieve market acceptance for our radiation therapy products, we often need to educate physicians about the use of a new treatment procedure such as IMRT, IGRT, VMAT, stereotactic radiosurgery or proton therapy, overcome physician objections to some of the effects of the product or its related treatment regimen, convince healthcare payors that the benefits of the product and its related treatment process outweigh its costs and help train qualified physicists in the skilled use of our products. For example, the complexity and dynamic nature of IMRT and IGRT requires significant education of hospital personnel and physicians regarding the benefits of IMRT and IGRT and the required departures from their customary practices. Further, the complexity and high cost of proton therapy requires similar significant education, as well as education regarding construction and facility requirements. We have expended and will continue to expend significant resources on marketing and educational efforts to create awareness of IMRT, IGRT, VMAT, stereotactic radiosurgery and proton therapy generally and to encourage the acceptance and adoption of our products for these technologies. We cannot be sure that any products we develop will gain significant market acceptance among physicians, patients and healthcare payors, even if we spend significant time and expense on their education.

***OUR BUSINESS MAY SUFFER IF WE ARE NOT ABLE TO HIRE AND RETAIN QUALIFIED PERSONNEL***

Our future success depends, to a significant extent, on our ability to attract, expand, integrate, train and retain our management team, qualified engineering personnel, technical personnel and sales and marketing staff. We compete for key personnel with other medical equipment and software manufacturers and technology companies, as well as universities and research institutions. Because this competition is intense, costs related to compensation could increase significantly if supply decreases or demand increases. If we are unable to hire, train or retain qualified personnel, we will not be able to maintain and expand our business, and our business would suffer.

***IF WE ARE NOT ABLE TO MATCH OUR MANUFACTURING CAPACITY WITH DEMAND FOR OUR PRODUCTS, OUR FINANCIAL RESULTS MAY SUFFER***

Our products have a long production cycle and we need to anticipate demand for our products in order to ensure adequate manufacturing or testing capacity. If we are unable to anticipate demand and our manufacturing or testing capacity does not keep pace with product demand, we will not be able to fulfill orders timely, which may negatively impact our financial results and overall business. Conversely, if demand for our products decreases, the fixed costs associated with excess manufacturing capacity may harm our financial results.

***IF WE FAIL TO SUCCESSFULLY ACQUIRE OR INTEGRATE NEW BUSINESSES, PRODUCTS AND TECHNOLOGY, WE MAY NOT REALIZE EXPECTED BENEFITS OR MAY HARM OUR BUSINESS***

We need to grow our businesses in response to changing technologies, customer demands and competitive pressures. In some circumstances, we may decide to grow our business through the acquisition of complementary businesses, products or technologies rather than through internal development. For example, in fiscal year 2009 we acquired certain assets of IKOE, a supplier of software used in the planning of radiotherapy and radiosurgery treatments. Identifying suitable acquisition candidates can be difficult, time-consuming and costly, and we may not be able to identify suitable candidates or successfully complete identified acquisitions. In addition, completing an acquisition can divert our management and key personnel from our business operations, which could harm our business and affect our financial results. Even if we complete an acquisition, we may not be able to successfully integrate newly acquired organizations, products, technologies or employees into our operations, or may not fully realize some of the expected synergies.

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Integrating an acquisition can also be expensive and time-consuming, and may strain our resources. It may cost us more to commercialize new products than we originally anticipated, as we are experiencing with our proton therapy systems. These additional expenditures could be significant and could cause our results of operations to suffer. In many instances, integrating a new business will also involve implementing or improving internal controls appropriate for a public company at a business that lacks them. In addition, we may be unable to retain the employees of acquired companies, or the acquired company's customers, suppliers, distributors or other partners for a variety of reasons, including the fact that these entities may be our competitors or may have close relationships with our competitors.

Further, we may find that we need to restructure or divest acquired businesses, or assets of those businesses. Even with restructuring activities or divestitures, an acquisition may not produce the full efficiencies and benefits we expect. Consequently, we may not achieve anticipated growth or other benefits from an acquisition, which could harm our existing business. If we decide to sell assets or a business, as we did in fiscal year 2008 with Research Instruments, it may be difficult to identify buyers or alternative exit strategies on acceptable terms, in a timely manner, or at all, which could delay the accomplishment of our strategic objectives, or we may dispose of a business at a price or on terms that are less than we had anticipated.

We account for our acquisitions under the purchase method of accounting. Under this method, we allocate the total purchase price to the acquired businesses' tangible assets and liabilities, identifiable intangible assets and in-process research and development costs based on their fair values as of the date of the acquisition, and record the excess of the purchase price over those fair values as goodwill. If we fail to achieve the anticipated growth from an acquisition, or if we decide to sell assets or a business, we may be required to recognize an impairment loss on the write down of our assets and goodwill, which could adversely affect our business and financial operations. In addition, acquisitions can result in potentially dilutive issuances of equity securities or the incurrence of debt, contingent liabilities or expenses, or other charges, any of which could harm our business and affect our financial results.

***WE MAY FACE ADDITIONAL RISKS FROM THE ACQUISITION OR DEVELOPMENT OF NEW LINES OF BUSINESS***

From time to time, we may acquire or develop new lines of business, such as proton therapy. There are substantial risks and uncertainties associated with this, particularly in instances where the markets are not fully developed. Risks include developing knowledge of and experience in the new business, recruiting market professionals, increasing research and development expenditures, and developing and capitalizing on new relationships with experienced market participants. This may mean significant investment and involvement of our senior management to acquire or develop, then integrate, the business into our operations. Timelines for integration of new businesses may not be achieved and price and profitability targets may not prove feasible, as new products can carry lower gross margins. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact whether implementation of a new business will be successful. Failure to manage these risks in the development and implementation of new businesses successfully could materially and adversely affect our business, results of operations and financial condition.

***WE MAY NOT BE ABLE TO SUCCESSFULLY RESOLVE RESIDUAL ISSUES RELATED TO THE SALE OF OUR RESEARCH INSTRUMENTS BUSINESS***

In the second quarter of fiscal year 2009, we completed the sale of the Research Instruments business, but retained responsibility for certain contracts. We may incur additional costs beyond those expected with these remaining obligations which could adversely affect our financial condition. Continued efforts related to managing these remaining obligations may require a substantial amount of management, administrative and operational resources, particularly if unanticipated difficulties with the fulfillment of these contracts are encountered. These demands may distract our employees and management from the day-to-day operation of our other businesses.

***WE WORK WITH DISTRIBUTORS FOR SALES IN SOME TERRITORIES, AND LOSING THEM COULD HARM OUR REVENUES IN THAT TERRITORY***

We have strategic relationships with a number of key distributors for sales and service of our products, principally in Europe and Asia. If these strategic relationships end and are not replaced, our revenues and/or ability to service our products in the territories serviced by these distributors could be adversely affected.

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***FLUCTUATIONS IN OUR OPERATING RESULTS, INCLUDING QUARTERLY NET ORDERS, REVENUES, AND GROSS MARGINS, MAY CAUSE OUR STOCK PRICE TO BE VOLATILE, WHICH COULD CAUSE LOSSES FOR OUR STOCKHOLDERS***

We have experienced and expect in the future to experience fluctuations in our operating results, including net orders, revenues and gross margins. Many of our products require significant capital expenditures by our customers. Accordingly, individual product orders can be quite large in dollar amounts, which can extend the customer purchasing cycle. We have experienced this with our IGRT products, and expect this to be even greater with our proton therapy products because of the high cost of the equipment and the complexity of project financing. As a result of the recent worldwide economic downturn and contraction in credit markets, as well as the uncertainty surrounding the impact of healthcare reform and changes to reimbursement rates, the purchasing cycle has extended and may extend even further as potential customers more closely scrutinize and prioritize their capital spending budgets, and analyze appropriate financing alternatives. With larger projects, such as the purchase of a proton therapy system, the contraction in credit markets could cause customers to delay or cancel their projects, or request our participation in financing arrangements or payment concessions in their agreements with us, which could negatively impact our cash flows and results of operations. In addition, some of our more sophisticated equipment, such as IGRT and proton therapy products, requires greater site preparation and longer construction cycles, which can delay customer decision cycles even further. The timing of when individual orders are placed, installation is accomplished and the revenues recognized affect our quarterly results.

Once orders are received, factors that may affect whether these orders become revenues and the timing include:

delay in shipment due, for example, to longer construction projects or unanticipated construction delays at customer locations where our products are to be installed, cancellations or rescheduling by customers, extreme weather conditions, natural disasters, port strikes or manufacturing difficulties;

delay in the installation and/or acceptance of a product;

for proton therapy systems, failure to satisfy contingencies associated with an order;

the method of accounting used to recognize revenue;

a change in a customer's financial condition or ability to obtain financing; or

appropriate regulatory approvals or authorizations.

Our quarterly operating results may also be affected by a number of other factors, including:

changes in our or our competitors' pricing or discount levels;

changes or anticipated changes in third-party reimbursement amounts or policies applicable to treatments using our products;

revenues becoming affected by seasonal influences;

timing of revenue recognition;

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changes in foreign currency exchange rates;

changes in the relative portion of our revenues represented by our various products, including the relative mix between higher margin and lower margin products;

changes in the relative portion of our revenues represented by the international regions;

timing of the announcement, introduction and delivery of new products or product enhancements by us and by our competitors;

fluctuation in our effective tax rate, which may or may not be known to us in advance;

disruptions in the supply or changes in the costs of raw materials, labor, product components or transportation services;

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disruptions in our operations, including our ability to manufacture products, caused by events such as earthquakes, fires, floods, terrorist attacks or the outbreak of epidemic diseases;

changes in the general economic conditions or tightening of credit available to our customers in the regions in which we do business;

unexpected levels of order cancellations;

the impact of changing levels of sales on sole purchasers of certain of our x-ray products;

the unfavorable outcome of any litigation or administrative proceeding or inquiry;

misleading information in the financial community; and

accounting changes, such as those relating to accounting reserves for product recalls, reserves for excess and obsolete inventories, share-based compensation expense, accounting for income taxes, and adoption of new accounting pronouncements.

Because many of our operating expenses are based on anticipated capacity levels and a high percentage of these expenses are fixed for the short term, a small variation in the timing of revenue recognition can cause significant variations in operating results from quarter to quarter. Our overall gross margin may also be impacted by the gross margin of our proton therapy products, which are presently below the gross margins for our traditional radiotherapy products. If our gross margins fall below the expectation of securities analysts and investors, the trading price of VMS common stock would almost certainly decline.

We report on a quarterly and annual basis our net orders and backlog. It is important to understand that, unlike revenues, net orders and backlog are not governed by the rules of GAAP, and are not within the scope of the audit or reviews conducted by our independent registered public accounting firm; therefore, investors should not interpret our net orders or backlog in such a manner. Also, for the reasons set forth above, our net orders and backlog cannot necessarily be relied upon as accurate predictors of future revenues. Unexpected levels of cancellation of orders or delays in customer purchase decisions or delivery dates will reduce the quarterly net orders and backlog and also affect the level of future revenues. Accordingly, we cannot be sure if or when orders will mature into revenues. Our net orders, backlog, revenues and net earnings in one or more future periods may fall below the expectations of securities analysts and investors. In that event, the trading price of VMS common stock would almost certainly decline.

***THE FINANCIAL RESULTS OF OUR VARIAN PARTICLE THERAPY BUSINESS MAY FLUCTUATE AND BE UNPREDICTABLE***

Our proton therapy projects are highly customized and vary in size and complexity. Planning for these projects will take more time and use more resources than those in the radiotherapy business conducted in our Oncology Systems segment. Due to its relatively large scale, the construction of a proton therapy facility requires significant capital investment and may involve complex project financing. If we are required to establish special purpose entities to finance and manage a proton therapy project, we may be required to consolidate these special purpose entities in our financial statements, or guarantee performance and assume liabilities that are in excess of the project value, which could negatively impact our financial results. Further, the recent worldwide economic downturn resulted in a contraction in credit markets. To the extent this persists, it may make it more difficult for potential customers of this business to find appropriate financing for large proton therapy projects, which could cause them to delay or cancel their projects, or request participation in financing arrangements or payment concessions in their agreements with us. In addition, due to their size and complexity, the sales and customer decision cycles for proton therapy projects may take several years. As a result, the timing of these projects, and therefore our operating results for this business, may vary significantly from period to period.

We expect that a limited number of customers will account for a substantial portion of our Particle Therapy business for the foreseeable future. Because an order for a proton therapy system can be relatively large, an order in one fiscal period will cause our financial results to vary significantly, making comparisons between fiscal periods more difficult. Further, the award of a proton therapy system orders may be subject to challenge by third parties, which can make the certainty of these orders unpredictable. If a customer cancels an order for a proton therapy system, such as recently occurred with the order for a proton therapy systems for Skandion Kliniken in Sweden, it would negatively impact our orders in the fiscal period in which the order is cancelled and we would lose the opportunity for the product and services revenues that the order

represents, which would adversely affect our financial results.

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In addition, many of the components used in proton therapy equipment require a long lead time, which may require an increase in our levels of inventory. This may cause fluctuations in the operating results of our Varian Particle Therapy business that may make it difficult to predict our operating results and to compare our financial results from period to period.

Moreover, entrance into the proton therapy business may subject us to increased risk and potential liability. For example, because proton therapy projects are large in scale and require detailed project planning, failure to deliver on our commitments could result in greater than expected liabilities, as we could be required to indemnify business partners and customers for losses suffered or incurred if we are unable to deliver our products in accordance with the terms of customer contracts. The greater size of proton projects means that the potential liability could similarly be greater. Additionally, customers are requesting that the systems vendor, as the primary technology provider, provide guarantees for and suffer penalties in relation to the overall construction project. Since the cost of each proton therapy center project may exceed \$100 million, the amount of potential liability may be higher than the levels historically assumed by us for our traditional radiation therapy business. Insurance covering these contingencies may be unobtainable. If we cannot reasonably mitigate or eliminate these contingencies, our ability to competitively bid upon proton center projects will be negatively impacted and we may be required to assume material amounts of potential liability, all of which may have adverse consequences to our Varian Particle Therapy business. In addition, we have encountered and may encounter additional challenges in the commercialization of the proton therapy products, which may increase our research and development costs and delay the introduction of our products. This and other unanticipated events could adversely affect our business and make our results of operations unpredictable.

### ***WE HAVE ENTERED INTO A CREDIT FACILITY AGREEMENT THAT RESTRICTS CERTAIN ACTIVITIES, AND FAILURE TO COMPLY WITH THIS AGREEMENT MAY HAVE AN ADVERSE EFFECT ON OUR BUSINESS, LIQUIDITY AND FINANCIAL POSITION***

We maintain a revolving credit facility that contains restrictive financial covenants, including financial covenants that require us to comply with specified financial ratios. We may have to curtail some of our operations to comply with these covenants. In addition, our revolving credit facility contains other affirmative and negative covenants that could restrict our operating and financing activities. These provisions limit our ability to, among other things, incur future indebtedness, contingent obligations or liens, guarantee indebtedness, make certain investments and capital expenditures, sell stock or assets and pay dividends, and consummate certain mergers or acquisitions. Because of the restrictions on our ability to create or assume liens, we may find it difficult to secure additional indebtedness if required. Furthermore, if we fail to comply with the credit facility requirements, we may be in default, and we may not be able to obtain the necessary amendments to the credit agreement or waivers of an event of default. Upon an event of default if the credit agreement is not amended or the event of default is not waived, the lender could declare all amounts outstanding, together with accrued interest, to be immediately due and payable. If this happens, we may not be able to make those payments or borrow sufficient funds from alternative sources to make those payments. Even if we were to obtain additional financing, that financing may be on unfavorable terms.

### ***CHANGES IN INTERPRETATION OR APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES MAY ADVERSELY AFFECT OUR OPERATING RESULTS***

We prepare our financial statements to conform with GAAP. These principles are subject to interpretation by the FASB, American Institute of Certified Public Accountants, the Public Company Accounting Oversight Board, the Securities and Exchange Commission and various other regulatory or accounting bodies. A change in interpretations of, or our application of, these principles can have a significant effect on our reported results and may even affect our reporting of transactions completed before a change is announced. Additionally, as we are required to adopt new accounting standards, our methods of accounting for certain items may change, which could cause our results of operations to fluctuate from period to period and make it more difficult to compare our financial results to prior periods. For example, as a result of our adoption in the first quarter of fiscal year 2008 of the provisions in ASC 740 related to accounting for uncertainty in income taxes, our effective tax rate and other related financial metrics have fluctuated and may in the future fluctuate more than they have in prior periods.

As our operations evolve over time, we may introduce new products or new technologies that require us to apply different accounting principles, including that regarding revenue recognition, than we have applied in past periods. Additionally, we recognize revenues for some of our proton therapy products and services and for certain highly customized image detection systems in our SIP business under the percentage-of-completion method or the completed-contract method, which affects the timing of revenue recognition. We could be required to apply these methods to other businesses in the future. The percentage-of-completion method involves considerable use of estimates in determining revenues, costs and profits and in



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assigning dollar amounts to relevant accounting periods which must be periodically reviewed and appropriately adjusted. If our estimates prove to be inaccurate or circumstances change over time, we would be required to adjust revenues or even record a contract loss in later periods, and our financial results could suffer. In addition, if a loss is expected on a contract under the percentage-of-completion method and completed contract method, the estimated loss would be charged to cost of sales in the period the loss is identified. The application of different types of accounting principles and related potential changes may make it more difficult to compare our financial results from quarter to quarter, and the trading price of VMS common stock could suffer or become more volatile as a result.

***ENVIRONMENTAL LAWS IMPOSE COMPLIANCE COSTS ON OUR BUSINESS AND CAN ALSO RESULT IN LIABILITY***

We are subject to environmental laws around the world. These laws regulate many aspects of our operations, including our handling, storage, transport and disposal of hazardous materials. They can also impose cleanup liabilities, including with respect to discontinued operations. Although we follow procedures intended to comply with existing environmental laws, we, like other businesses, can never completely eliminate the risk of contamination or injury from certain materials that we use in our business and, therefore, the prospect of resulting claims and damage payments. We may also be assessed fines or penalties for failure to comply with environmental laws and regulations. As a consequence of these various elements, we can incur significant environmental costs and liabilities, some recurring and reasonably predictable, and others not recurring or easily predicted. Although insurance has provided coverage for portions of cleanup costs resulting from historical occurrences, we maintain only limited insurance coverage for costs or claims that might result from any future contamination.

Future changes in environmental laws could also increase our costs of doing business, perhaps significantly. Several countries, including some in the EU, now require medical equipment manufacturers to bear certain disposal costs, of products at the end of a product's useful life, thus creating increased costs for our operations. The EU has also adopted a directive that may lead to restrictions on the use of certain hazardous substances in some of our products sold there. These directives, along with another that requires material disclosure information to be provided upon request, could create increased costs for our operations. All of these costs, and any future violations or liabilities under environmental laws or regulations, could have a material adverse effect on our business.

***AS A STRATEGY TO ASSIST OUR SALES EFFORTS, WE MAY OFFER EXTENDED PAYMENT TERMS, WHICH MAY POTENTIALLY RESULT IN HIGHER DSO AND GREATER PAYMENT DEFAULTS***

We offer longer or extended payment terms for qualified customers in some circumstances. As of April 2, 2010, customer contracts with extended payment terms of more than one year amounted to less than 1% of our accounts receivable balance. While we qualify customers to whom we offer longer or extended payment terms, their financial positions may change adversely over the longer time period given for payment. This may result in an increase in payment defaults, which would affect our net earnings. Also, longer or extended payment terms have and may in the future result in an increase in our days sales outstanding.

***DISRUPTION OF CRITICAL INFORMATION SYSTEMS COULD HARM OUR BUSINESS AND FINANCIAL CONDITION***

Information technology helps us operate efficiently, interface with customers, maintain financial accuracy and efficiency, and accurately produce our financial statements. If we do not allocate and effectively manage the resources necessary to build and sustain the proper technology infrastructure, we could be subject to transaction errors, processing inefficiencies, the loss of customers, business disruptions, or the loss of or damage to intellectual property through security breach. If our data management systems do not effectively collect, store, process and report relevant data for the operation of our business, whether due to equipment malfunction or constraints, software deficiencies, or human error, our ability to effectively plan, forecast and execute our business plan and comply with applicable laws and regulations will be impaired, perhaps materially. Any such impairment could materially and adversely affect our financial condition, results of operations, cash flows and the timeliness with which we report our internal and external operating results.

***OUR OPERATIONS ARE VULNERABLE TO INTERRUPTION OR LOSS DUE TO NATURAL OR OTHER DISASTERS, POWER LOSS, STRIKES AND OTHER EVENTS BEYOND OUR CONTROL***

We conduct a significant portion of our activities, including manufacturing, administration and data processing at facilities located in the State of California and other seismically active areas that have experienced major earthquakes in the past, as

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well as other disasters. We carry limited earthquake insurance that may not be adequate or continue to be available at commercially reasonable rates and terms. A major earthquake or other disaster (such as a major fire, flood, volcanic eruption or terrorist attack) affecting our facilities, or those of our suppliers, could significantly disrupt our operations, and delay or prevent product manufacture and shipment during the time required to repair, rebuild or replace our or our suppliers' damaged manufacturing facilities; these delays could be lengthy and costly. If any of our customers' facilities are adversely affected by a disaster, shipments of our products could be delayed. In addition, our facilities, particularly those located in the western states of the United States, may be subject to a shortage of available electrical power and other energy supplies. Any shortages may increase our costs for power and energy supplies or could result in blackouts, which could disrupt the operations of our affected facilities and harm our business. Further, our products are typically shipped from a limited number of ports, and any disaster, strike or other event blocking shipment from these ports could delay or prevent shipments and harm our business.

***THE EFFECT OF TERRORISM OR AN OUTBREAK OF EPIDEMIC DISEASES MAY NEGATIVELY AFFECT SALES AND HINDER OUR OPERATIONS***

Concerns about terrorism, the effects of a terrorist attack or an outbreak of epidemic diseases, such as the swine flu, could have a negative effect on our business operations, those of our suppliers and customers, and the ability to travel, resulting in adverse consequences on our revenues and financial performance.

**Table of Contents****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

(a) Not applicable

(b) Not applicable

(c) The following table provides information with respect to the shares of common stock repurchased by us during the second quarter of fiscal year 2010.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
January 2, 2010 - January 29, 2010	557,208(2)	\$ 48.01	551,700	4,448,300
January 30, 2010 - February 26, 2010	687,039(3)	\$ 48.26	548,300	3,900,000
February 27, 2010 - April 2, 2010	350,000	\$ 53.09	350,000	3,550,000
Total	1,594,247	\$ 49.23	1,450,000	

- (1) On November 17, 2008, VMS's Board of Directors authorized the repurchase of 8,000,000 shares of VMS common stock from January 1, 2009 through December 31, 2009. The authorization expired on December 31, 2009 with 6,050,000 shares available for repurchase. On November 13, 2009, VMS's Board of Directors authorized the repurchase of an additional 5,000,000 shares of VMS common stock from January 1, 2010 through December 31, 2010. We expect repurchases under the November 13, 2009 authorization will be made in accordance with Rule 10b-18 and include plans designed to satisfy the Rule 10b5-1 safe harbor. Shares will be retired upon repurchase.
- (2) Includes 5,508 shares of VMS common stock that were tendered to VMS in satisfaction of tax withholding obligations upon the vesting of restricted common stock granted under the Company's employee stock plans.
- (3) Includes 138,739 shares of VMS common stock that were tendered to VMS in satisfaction of tax withholding obligations upon the vesting of restricted common stock and restricted stock units granted under the Company's employee stock plans.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Reserved****Item 5. Other Information**

**Table of Contents****Submission of Matters to a Vote of Security Holders**

At our Annual Meeting of Stockholders held on February 11, 2010 (the "Stockholders Meeting"), the stockholders of Varian Medical Systems, Inc. voted on the following four proposals and cast their votes as follows:

Proposal One:

To elect the following individuals to serve as directors for three-year terms ending with the 2013 Annual Meeting of Stockholders:

	<b>For</b>	<b>Withheld</b>	<b>Broker Non-Votes</b>
John Seely Brown	89,397,080	1,301,472	13,300,217
R. Andrew Eckert	89,648,015	1,050,537	13,300,217
Mark R. Laret	83,969,529	6,729,023	13,300,217

Directors Richard M. Levy, Susan L. Bostrom, Timothy E. Guertin, David W. Martin, Jr., Ruediger Naumann-Etienne and Venkatraman Thyagarajan continued in office following the Stockholders Meeting.

Proposal Two:

To approve an amendment to the Second Amended and Restated Varian Medical Systems, Inc. 2005 Omnibus Stock Plan to increase the number of shares available for award thereunder.

	<b>For</b>	<b>Against</b>	<b>Abstain</b>	<b>Broker Non-Votes</b>
	64,121,037	26,443,285	134,230	13,300,217

Proposal Three:

To approve the Varian Medical Systems, Inc. 2010 Employee Stock Purchase Plan.

	<b>For</b>	<b>Against</b>	<b>Abstain</b>	<b>Broker Non-Votes</b>
	87,556,812	3,025,259	116,480	13,300,217

Proposal Four:

To ratify the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for fiscal year 2010.

	<b>For</b>	<b>Against</b>	<b>Abstain</b>	<b>Broker Non-Votes<sup>(1)</sup></b>
	102,712,911	1,201,444	84,414	N/A

(1) Pursuant to the rules of the New York Stock Exchange, this proposal constituted a routine matter. Therefore, brokers were permitted to vote without receipt of instructions from beneficial owners.

**Change in Control Agreements**

On February 12, 2010, the Board of Directors of Varian Medical Systems, Inc. approved new forms of change in control agreements for executive officers that are hired, appointed or change positions on or after February 12, 2012. None of the 12 executive officers and key employees who have existing change in control agreements are currently a party to these new agreements, and existing change of control agreements are not being amended at this time. The new agreements are substantially similar to the existing change of control agreements,

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except that the new agreements replace the prior forms 280G excise tax restoration provision with a 280G cut-back provision that is further described below.

Under the existing and new change-in-control agreements with senior executives, including our named executive officers, we will pay any of these executives who are terminated other than for death, disability, retirement or cause, or who resign due to good reason (as each of those terms are defined in the agreements) within 18 months after a change in control (as defined in the agreements), a lump sum severance amount equal to 3.0 (in the case of our chief executive officer), 2.5 (in the case of our other named executive officers) or 2.0 (in the case of other key employees) times the sum of the individual's then-current annual base salary, plus the greater of (a) the individual's most recently established target annual bonus, or (b) the average annual bonus that was paid to the individual in the three fiscal years (or lesser number of full fiscal years completed by the individual) ending before the termination date. The termination payments and benefits under the agreements may also be triggered under certain circumstances following a change in control (as defined in the agreements), as determined under

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the agreements. Cause includes, generally, willful failure to perform one's duties, fraud and certain wrongful acts, felony convictions and court or regulatory orders requiring termination. Good reason includes, generally, a material change in duties or material reduction in authority or responsibility, a reduction in total compensation except when an equivalent reduction occurs for the entire class of other similar executives, a material change in employee benefits, relocation and certain breaches of the agreement by us.

In addition, under the existing and new agreements, if an individual is terminated under the circumstances described above, then unvested stock options and restricted stock will fully vest as of the individual's termination date. In addition, we will continue certain insurance and other benefits of the individual under the then-existing terms for up to 24 months (or, if earlier, the start of full-time employment with a new employer), pay the individual a lump sum pro-rata bonus at target for the applicable performance period(s) in which the termination occurs, and provide the individual an election to purchase the automobile leased under our executive car program, if any.

The existing and new agreements also provide for certain death and long-term disability benefits in the event of an individual's death or disability within 18 months after a change in control. Payments and benefits may be delayed six months following separation from service in order to avoid onerous taxation under Section 409A of the Internal Revenue Code.

Under the existing change in control agreements, if any payments or benefits (including those under these agreements) would result in the imposition of an excise tax imposed by Section 280G of the Internal Revenue Code and the amount of such payments and benefits exceeds the threshold limit imposed by 280G by 10% or more, then the individual will receive a tax restoration payment in an amount that will place the individual in the same after-tax economic position that the individual would have been in but for the imposition of the excise tax. If the amount of such payments and benefits exceeds the threshold limit by less than 10%, then the amount received by the individual will instead be reduced so that the aggregate payments and benefits to be received by the individual will be \$1.00 less than the threshold imposed under Section 280G.

Under the new change in control agreements, we replaced the 280G excise tax restoration provision described in the preceding paragraph with a provision that provides that the executive receive either all of his or her change in control payments or benefits (including those under these agreements) or such portion thereof as will not be subject to excise taxes under 280G, whichever results in a greater after-tax benefit to the executive.

**Table of Contents****Item 6. Exhibits**

(a) Exhibits required to be filed by Item 601 of Regulation S-K:

<b>Exhibit No.</b>	<b>Description</b>
10.1	Registrant's 2010 Employee Stock Purchase Plan.
10.2	Amendment No. 4 to Registrant's Second Amended and Restated 2005 Omnibus Stock Plan.
10.3	Form of Registrant's Restricted Stock Unit Agreement under the Registrant's Second Amended and Restated 2005 Omnibus Stock Plan.
10.4	Form of Registrant's Change in Control Agreement for Chief Executive Officer (effective on or after February 12, 2012).
10.5	Form of Registrant's Change in Control Agreement for Senior Executives (Chief Financial Officer and General Counsel) (effective on or after February 12, 2012).
10.6	Form of Registrant's Change in Control Agreement for Senior Executives (other than the Chief Executive Officer, the Chief Financial Officer, and the General Counsel) (effective on or after February 12, 2012).
10.7	Form of Registrant's Change in Control Agreement for Key Employees (effective on or after February 12, 2012).
15.1	Letter Regarding Unaudited Interim Financial Information.
31.1	Chief Executive Officer Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act.
31.2	Chief Financial Officer Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act.
32.1	Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

Attached as Exhibit 101 to this Quarterly Report on Form 10-Q are the following formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Statements of Earnings for the three and six months ended April 2, 2010 and April 3, 2009; (ii) Condensed Consolidated Balance Sheets at April 2, 2010 and October 2, 2009; (iii) Condensed Consolidated Statements of Cash Flows for the six months ended April 2, 2010 and April 3, 2009; and (iv) Notes to Condensed Consolidated Financial Statements for the three and six months ended April 2, 2010.

In accordance with Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**VARIAN MEDICAL SYSTEMS, INC.**  
*(Registrant)*

Dated: May 11, 2010

By: */s/ ELISHA W. FINNEY*  
Elisha W. Finney  
Senior Vice President, Finance and  
Chief Financial Officer  
*(Duly Authorized Officer and  
Principal Financial Officer)*

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