

MASIMO CORP  
Form 10-Q  
November 02, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 29, 2012

OR

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

For the transition period from            to

Commission File Number 001-33642

**Masimo Corporation**

(Exact Name of Registrant as Specified in its Charter)

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**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**33-0368882**  
(I.R.S. Employer  
Identification Number)

**40 Parker**

**Irvine, California**  
(Address of Principal Executive Offices)

**92618**  
(Zip Code)

**(949) 297-7000**  
(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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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:

| Class                           | Number of Shares Outstanding as of September 29, 2012 |
|---------------------------------|---|
| Common stock, \$0.001 par value | 57,232,216  |

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**MASIMO CORPORATION**  
**FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 29, 2012**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****MASIMO CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(unaudited) (in thousands, except par values)**

|  | September 29,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
| <b>ASSETS</b>  |                       |                      |
| Current assets   |                       |                      |
| Cash and cash equivalents  | \$ 112,988            | \$ 129,882           |
| Accounts receivable, net of allowance for doubtful accounts of \$1,724 and \$1,798 at September 29, 2012 and December 31, 2011, respectively | 62,998                | 57,013               |
| Royalties receivable   | 7,169                 | 7,102                |
| Inventories  | 48,981                | 45,944               |
| Prepaid expenses   | 12,934                | 9,410                |
| Deferred tax assets  | 11,574                | 11,576               |
| Other current assets   | 3,554                 | 2,008                |
| Total current assets   | 260,198               | 262,935              |
| Deferred cost of goods sold  | 51,539                | 51,679               |
| Property and equipment, net  | 23,028                | 15,239               |
| Intangible assets, net   | 27,288                | 11,393               |
| Goodwill   | 22,745                | 448                  |
| Deferred tax assets  | 17,308                | 16,766               |
| Other assets   | 7,511                 | 7,644                |
| Total assets   | \$ 409,617            | \$ 366,104           |
| <b>LIABILITIES AND EQUITY</b>  |                       |                      |
| Current liabilities  |                       |                      |
| Accounts payable   | \$ 26,024             | \$ 27,302            |
| Accrued compensation   | 22,559                | 19,717               |
| Accrued liabilities  | 16,580                | 12,297               |
| Income taxes payable   | 492                   | 570                  |
| Deferred revenue   | 18,784                | 16,019               |
| Current portion of capital lease obligations   | 55                    | 48                   |
| Total current liabilities  | 84,494                | 75,953               |
| Deferred revenue   | 709                   | 984                  |
| Capital lease obligations, less current portion  | 74                    | 74                   |
| Other liabilities  | 10,070                | 9,427                |
| Total liabilities  | 95,347                | 86,438               |
| Commitments and contingencies  |                       |                      |
| Equity   |                       |                      |
| Masimo Corporation stockholders' equity:   |                       |                      |
| Preferred stock, \$0.001 par value; 5,000 shares authorized; 0 shares issued and outstanding at September 29, 2012 and December 31, 2011     |                       |                      |

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|  |            |            |
|--|------------|------------|
| Common stock, \$0.001 par value; 100,000 shares authorized; 57,232 and 58,247 shares outstanding at September 29, 2012 and December 31, 2011, respectively | 57         | 58         |
| Treasury stock, 3,156 and 2,001 shares at September 29, 2012 and December 31, 2011, respectively   | (63,664)   | (37,396)   |
| Additional paid-in capital   | 255,465    | 243,528    |
| Accumulated other comprehensive income   | 3,053      | 1,274      |
| Retained earnings  | 116,629    | 69,364     |
| <br>   |            |            |
| Total Masimo Corporation stockholders' equity  | 311,540    | 276,828    |
| Noncontrolling interest  | 2,730      | 2,838      |
| <br>   |            |            |
| Total equity   | 314,270    | 279,666    |
| <br>   |            |            |
| Total liabilities and equity   | \$ 409,617 | \$ 366,104 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****MASIMO CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(unaudited) (in thousands, except per share amounts)**

|  | <b>Three Months Ended</b>     |                            | <b>Nine Months Ended</b>      |                            |
|--|-------------------------------|----------------------------|-------------------------------|----------------------------|
|  | <b>September 29,<br/>2012</b> | <b>October 1,<br/>2011</b> | <b>September 29,<br/>2012</b> | <b>October 1,<br/>2011</b> |
| <b>Revenue:</b>  |                               |                            |                               |                            |
| Product  | \$ 112,108                    | \$ 97,639                  | \$ 339,644                    | \$ 301,771                 |
| Royalty  | 6,961                         | 6,401                      | 21,428                        | 24,876                     |
| <b>Total revenue</b>   | <b>119,069</b>                | <b>104,040</b>             | <b>361,072</b>                | <b>326,647</b>             |
| Cost of goods sold   | 40,736                        | 35,601                     | 122,002                       | 106,125                    |
| <b>Gross profit</b>  | <b>78,333</b>                 | <b>68,439</b>              | <b>239,070</b>                | <b>220,522</b>             |
| <b>Operating expenses:</b>   |                               |                            |                               |                            |
| Selling, general and administrative  | 48,260                        | 40,134                     | 142,381                       | 125,275                    |
| Research and development   | 12,121                        | 9,372                      | 33,736                        | 28,793                     |
| <b>Total operating expenses</b>  | <b>60,381</b>                 | <b>49,506</b>              | <b>176,117</b>                | <b>154,068</b>             |
| <b>Operating income</b>  | <b>17,952</b>                 | <b>18,933</b>              | <b>62,953</b>                 | <b>66,454</b>              |
| Non-operating income (expense)   | 912                           | (240)                      | (132)                         | 482                        |
| <b>Income before provision for income taxes</b>                              | <b>18,864</b>                 | <b>18,693</b>              | <b>62,821</b>                 | <b>66,936</b>              |
| Provision for income taxes   | 5,301                         | 3,869                      | 15,724                        | 17,049                     |
| <b>Net income including noncontrolling interest</b>                          | <b>13,563</b>                 | <b>14,824</b>              | <b>47,097</b>                 | <b>49,887</b>              |
| Net (income) loss attributable to the noncontrolling interest                | 231                           | 5                          | 168                           | (7)                        |
| <b>Net income attributable to Masimo Corporation stockholders</b>            | <b>13,794</b>                 | <b>14,829</b>              | <b>47,265</b>                 | <b>49,880</b>              |
| <b>Other comprehensive income, net of tax:</b>                               |                               |                            |                               |                            |
| Foreign currency translation adjustments                                     | 1,836                         | 202                        | 1,779                         | 369                        |
| <b>Comprehensive income attributable to Masimo Corporation stockholders</b>  | <b>\$ 15,630</b>              | <b>\$ 15,031</b>           | <b>\$ 49,044</b>              | <b>\$ 50,249</b>           |
| <b>Net income per share attributable to Masimo Corporation stockholders:</b> |                               |                            |                               |                            |
| Basic  | \$ 0.24                       | \$ 0.25                    | \$ 0.82                       | \$ 0.83                    |
| Diluted  | \$ 0.24                       | \$ 0.24                    | \$ 0.81                       | \$ 0.82                    |
| <b>Weighted average shares used in per share calculations:</b>               |                               |                            |                               |                            |
| Basic  | 57,201                        | 59,971                     | 57,507                        | 59,804                     |
| Diluted  | 58,145                        | 61,086                     | 58,454                        | 61,082                     |

The accompanying notes are an integral part of these condensed consolidated financial statements.



**Table of Contents****MASIMO CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited) (in thousands)**

|   | <b>Nine Months Ended</b> |                   |
|---|--------------------------|-------------------|
|   | <b>September 29,</b>     | <b>October 1,</b> |
|   | <b>2012</b>              | <b>2011</b>       |
| <b>Cash flows from operating activities:</b>  |                          |                   |
| Net income including noncontrolling interest  | \$ 47,097                | \$ 49,887         |
| Adjustments to reconcile net income including noncontrolling interest to net cash provided by operating activities: |                          |                   |
| Depreciation and amortization   | 6,509                    | 5,608             |
| Share-based compensation  | 11,033                   | 10,167            |
| Provision (benefit) for doubtful accounts   | (5)                      | 184               |
| Provision for obsolete inventory  | 617                      | 1,879             |
| Provision for warranty costs  | 1,866                    | 1,919             |
| Benefit from deferred income taxes  | (319)                    |                   |
| Income tax benefit from exercise of stock options granted prior to January 1, 2006                                  | 259                      | 1,290             |
| Excess tax (deficit) benefit from share-based payment arrangements  | 340                      | (58)              |
| Realized foreign exchange loss on forward contracts   | 45                       |                   |
| Changes in operating assets and liabilities:  |                          |                   |
| Increase in accounts receivable   | (4,982)                  | (4,016)           |
| (Increase) decrease in royalties receivable   | (67)                     | 5,264             |
| Increase in inventories   | (1,700)                  | (2,374)           |
| (Increase) decrease in deferred cost of goods sold  | 160                      | (4,321)           |
| Increase in prepaid expenses  | (2,888)                  | (5,459)           |
| Increase in other assets  | (1,316)                  | (436)             |
| Decrease in accounts payable  | (2,730)                  | (2,146)           |
| Increase (decrease) in accrued compensation   | 2,344                    | (2,744)           |
| Increase (decrease) in accrued liabilities  | 820                      | (1,001)           |
| Increase (decrease) in income taxes payable   | (419)                    | 1,249             |
| Increase (decrease) in deferred revenue   | 2,490                    | (1,927)           |
| Increase (decrease) in other liabilities  | (2,196)                  | 1,101             |
| Net cash provided by operating activities   | 56,958                   | 54,066            |
| <b>Cash flows from investing activities:</b>  |                          |                   |
| Purchases of property and equipment   | (7,812)                  | (3,508)           |
| Increase in intangible assets   | (2,904)                  | (1,719)           |
| Cash paid for acquisitions  | (37,399)                 |                   |
| Net cash used in investing activities   | (48,115)                 | (5,227)           |
| <b>Cash flows from financing activities:</b>  |                          |                   |
| Repayments of capital lease obligations   | (12)                     | (37)              |
| Proceeds from issuance of common stock  | 1,034                    | 5,568             |
| Excess tax deficit (benefit) from share-based payment arrangements  | (340)                    | 58                |
| Repurchases of common stock   | (26,268)                 |                   |
| Net proceeds from settlement of forward contracts   | 88                       |                   |
| Net cash provided by (used in) financing activities   | (25,498)                 | 5,589             |



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|  |            |            |
|--|------------|------------|
| Effect of foreign currency exchange rates on cash    | (239)      | 459        |
| Net increase (decrease) in cash and cash equivalents | (16,894)   | 54,887     |
| Cash and cash equivalents at beginning of period     | 129,882    | 88,305     |
| Cash and cash equivalents at end of period           | \$ 112,988 | \$ 143,192 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**MASIMO CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1. Description of the Company**

Masimo Corporation, or the Company, is a global medical technology company that develops, manufactures, and markets noninvasive patient monitoring products. The Company's mission is to improve patient outcomes and reduce cost of care by taking noninvasive monitoring to new sites and applications. The Company invented Masimo Signal Extraction Technology, or Masimo SET<sup>®</sup>, which provides the capabilities of Measure-Through Motion and Low Perfusion pulse oximetry to address the primary limitations of conventional pulse oximetry. The Company has also developed Masimo rainbow<sup>®</sup> SET products which monitor multiple blood measurements, including oxygen content, carboxyhemoglobin, methemoglobin and hemoglobin. Additional rainbow<sup>®</sup> SET measurements that assist clinicians are Pleth Variability Index, respiration rate and Halo Index<sup>™</sup>. The Company develops, manufactures and markets a family of patient monitoring solutions which incorporate a monitor or circuit board and sensors, including proprietary single-patient use, reusable and responsible sensors, and cables. The Company considers the pulse oximetry device (monitor or circuit board), its sensors and cables and software fees to be products as defined in its condensed consolidated statements of comprehensive income. The Company sells to hospitals and the alternate care market through its direct sales force and distributors, and markets its circuit boards containing the Company's proprietary algorithm and software architecture to original equipment manufacturer, or OEM, partners.

**2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, have been condensed or omitted pursuant to such rules and regulations. The condensed consolidated financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to present fairly the Company's condensed consolidated financial statements. The condensed consolidated balance sheet as of December 31, 2011 was derived from the Company's audited consolidated financial statements at that date. The accompanying condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company's Annual Report on Form 10-K, filed with the SEC on February 17, 2012. The results for the three and nine months ended September 29, 2012 are not necessarily indicative of the results to be expected for the year ending December 29, 2012 or for any other interim period or for any future year.

***Principles of Consolidation***

The condensed consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries and the variable interest entity, or VIE, of which the Company is the primary beneficiary. All intercompany accounts and transactions have been eliminated in consolidation. In accordance with GAAP, current authoritative guidance is applied when determining whether an entity is subject to consolidation.

***Fiscal Periods***

The Company follows a conventional 52/53 week fiscal year. Under a conventional 52/53 week fiscal year, a 52 week year includes four quarters of 13 fiscal weeks while a 53 week fiscal year includes three 13 fiscal week quarters and one 14 fiscal week quarter. Fiscal 2011 was on a 52 week fiscal calendar in which the Company's first, second and third quarters ended on Saturday April 2, July 2 and October 1, 2011, respectively, and its fiscal year ended on Saturday, December 31, 2011. Fiscal 2012 is on a 52 week fiscal calendar in which the Company's first, second and third quarters ended on Saturday March 31, 2012, June 30, 2012 and September 29, 2012, respectively, and its fiscal year will end on Saturday, December 29, 2012.

***Use of Estimates***

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The Company prepares its financial statements in conformity with GAAP, which requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant estimates include: determination of accounts receivable allowances, inventory reserves, assets acquired in connection with a business combination, warranty reserves, rebate reserves, valuation of the Company's stock options, distributor channel inventory, royalty revenues, deferred revenue and uncertain income tax positions. Actual results could differ from those estimates.

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)*****Fair Value Measurements***

This authoritative guidance describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value:

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

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

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

Pursuant to current authoritative guidance, entities are allowed an irrevocable option to elect fair value for the initial and subsequent measurement for specified financial assets and liabilities on a contract-by-contract basis. The Company did not elect the fair value option under this guidance as to specific assets or liabilities. There were no transfers between level 1, level 2 and level 3 inputs during the three and nine months ended September 29, 2012. The Company carries cash and cash equivalents at cost which approximates fair value. For additional discussion of cash and cash equivalents, see Note 5 to the condensed consolidated financial statements.

The following tables represent the Company's fair value hierarchy for its financial assets (in thousands):

|                    | Fair Value Measurement as of September 29, 2012 using: |         |         |           |
|--------------------|--|---------|---------|-----------|
|                    | Level 1  | Level 2 | Level 3 | Total     |
| Assets:            |  |         |         |           |
| U.S. Treasuries    | \$ 67,993  | \$      | \$      | \$ 67,993 |
| Money Market funds | 1,627  |         |         | 1,627     |
| Total              | \$ 69,620  | \$      | \$      | \$ 69,620 |

|                    | Fair Value Measurement as of December 31, 2011 using: |         |         |           |
|--------------------|---|---------|---------|-----------|
|                    | Level 1   | Level 2 | Level 3 | Total     |
| Assets:            |   |         |         |           |
| U.S. Treasuries    | \$ 67,800   | \$      | \$      | \$ 67,800 |
| Money Market funds | 1,337   |         |         | 1,337     |
| Total              | \$ 69,137   | \$      | \$      | \$ 69,137 |

***Accounts Receivable and Allowance for Doubtful Accounts***

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Accounts receivable consist of trade receivables recorded upon recognition of revenue for product revenues, reduced by reserves for estimated bad debts and returns. Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Credit is extended based on evaluation of the customer's financial condition. Collateral is not required. The allowance for doubtful accounts is determined based on historical write-off experience, current customer information and other relevant factors, including specific identification of past due accounts, based on the age of the receivable in excess of the contemplated or contractual due date. Accounts are charged off against the allowance when the Company believes they are uncollectible.

### *Intangible Assets*

Costs to renew intangibles are capitalized and amortized over the remaining useful life of the intangible. For the three and nine months ended September 29, 2012, total renewal costs capitalized for patents were \$0.1 million and \$0.3 million, respectively. For the three and nine months ended September 29, 2012, total renewal costs capitalized for trademarks were \$25,000 and \$48,000, respectively. As of September 29, 2012, the weighted average number of years until the next renewal is one year for patents and six years for trademarks.

The Company's policy is to renew its patents and trademarks. The Company continually evaluates the amortization period and carrying basis of patents and trademarks to determine whether any events or circumstances warrant a revised estimated useful life or reduction in value. Capitalized application costs are charged to operations when it is determined that the patent or trademark will not be obtained or is abandoned.

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**MASIMO CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

***Impairment of Goodwill and Intangible assets***

The Company follows the current authoritative guidance for goodwill and intangible asset impairment. The Company first performs a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed two-step goodwill impairment test. Otherwise, the two-step goodwill impairment test is not required. In the first step of the goodwill impairment test, the estimated fair value of the reporting unit is compared with its carrying amount, including goodwill. If the estimated fair value is less than the carrying amount, then a second step must be completed in order to determine the amount of the goodwill impairment. In the second step, the implied fair value of the goodwill is determined by allocating the fair value of all of the reporting unit's assets and liabilities other than goodwill in a manner similar to a purchase price allocation. The resulting implied fair value of the goodwill that results from the allocation is then compared to the carrying amount of the goodwill and an impairment charge is recorded for the difference.

The Company reviews long-lived assets and identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted operating cash flow expected to be generated by the asset. If such asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount exceeds the fair value of the asset. Long-lived assets to be disposed of are reported at the lower of carrying amount or fair value less costs to sell.

No impairment of goodwill, intangible assets, or other long-lived assets was recorded during the three and nine months ended September 29, 2012 or October 1, 2011.

***Revenue Recognition***

The Company follows the current authoritative guidance for software revenue recognition. Based on these requirements, the Company recognizes revenue when: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the price is fixed or determinable, and (iv) collectability is reasonably assured. The Company enters into agreements to sell pulse oximetry and related products and services as well as multiple deliverable arrangements that include various combinations of products and services. While the majority of the Company's sales transactions contain standard business terms and conditions, there are some transactions that contain non-standard business terms and conditions. As a result, contract interpretation is sometimes required to determine the appropriate accounting including: (a) whether an arrangement exists, (b) how the arrangement consideration should be allocated among the deliverables if there are multiple deliverables, (c) when to recognize revenue on the deliverables, and (d) whether undelivered elements are essential to the functionality of the delivered elements. Changes in judgments on these assumptions and estimates could materially impact the timing of revenue recognition.

In September 2009, the Financial Accounting Standards Board, or FASB, amended the accounting standards related to revenue recognition for arrangements with multiple deliverables. The new standard changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable to be based on the relative selling price. The FASB also amended the accounting standards for revenue recognition to exclude software that is contained in a tangible product from the scope of software revenue guidance if the software is essential to the tangible product's functionality. The Company adopted these new standards on a prospective basis. Therefore, the new standards apply only to revenue arrangements entered into or materially modified beginning January 2, 2011. Revenue arrangements entered into or modified prior to January 2, 2011 continue to be accounted for under the prior authoritative guidance. For revenue arrangements that were entered into or materially modified after the adoption of these standards, implementation of this new authoritative guidance had no significant impact on the Company's reported revenue in fiscal 2011 as compared to revenue if the related arrangements entered into or materially modified after the effective date were subject to the accounting requirements in effect in the prior year.

The new standards establish a hierarchy to determine the selling price to be used for allocating revenue to deliverables as follows:

(i) vendor-specific objective evidence of fair value, or VSOE, (ii) third-party evidence of selling price, or TPE, and (iii) best estimate of the selling price, or ESP. VSOE of fair value is defined as the price charged when the same element is sold separately. VSOE generally exists only when the deliverable is sold separately and is the price actually charged for that deliverable. TPE generally does not exist for the majority of the

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Company's products because of their uniqueness. The objective of ESP is to determine the price at which the Company would transact a sale if the product was sold on a stand-alone basis. In the absence of VSOE and TPE, the Company determines ESP for its products by considering multiple factors including, but not limited to, features and functionality of the product, geographies, type of customer, contractual prices pursuant to Group Purchasing Organization, or GPO, contracts, the Company's pricing and discount practices, and market conditions.

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**MASIMO CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

A deliverable in an arrangement qualifies as a separate unit of accounting if the delivered item has value to the customer on a stand-alone basis. Most of the Company's products in a multiple deliverable arrangement qualify as separate units of accounting. In the case of the Company's monitoring equipment products containing embedded Masimo SET software, the Company has determined that the hardware and software components function together to deliver the products' essential functionality, and therefore, represent a single deliverable. In accordance with the new guidance, the revenue from the sale of these products no longer falls within the scope of the software revenue recognition guidance. Software deliverables, such as rainbow parameter software, which do not function together with hardware components to provide the products' essential functionality, continue to be accounted for under software revenue recognition guidance. The Company's multiple deliverable arrangements may therefore have software deliverables that are subject to the existing software revenue recognition guidance. The revenue for these multiple-element arrangements is allocated to the software deliverables and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy in the new revenue recognition accounting guidance for arrangements with multiple deliverables.

The Company's sales under long-term sensor purchase contracts are generally structured such that the Company agrees to provide up-front and at no charge certain monitoring equipment, software, installation, training and ongoing warranty support in exchange for the hospital's agreement to purchase sensors over the term of the agreement, which ranges from three to six years. The sensors are essential to the functionality of the monitoring equipment and, therefore, represent a substantive performance obligation. The Company does not recognize any revenue when the monitoring and related equipment and software are delivered to the hospitals and installation and training is complete. The Company recognizes revenue for these delivered elements, on a pro-rata basis, as the sensors are delivered under the long-term purchase commitment. The adoption of the new guidance for revenue recognition did not change this pattern of revenue recognition for long-term sensor purchase contracts. The cost of the monitoring equipment initially placed at the hospitals is deferred and amortized to cost of goods sold over the life of the underlying long-term sensor purchase contract.

The Company's distributors purchase primarily sensor products which they then resell to hospitals that are typically fulfilling their purchase obligations to the Company under the end-user hospitals' long-term sensor purchase commitments. Upon shipment to the distributor, revenue is deferred until the Company's commitment to its end-user hospital is fulfilled, which occurs when the sensors are sold by the distributor to the end-user hospital. The Company also provides certain end-user hospitals with the ability to purchase sensors under rebate programs. Under these programs, the end-user hospitals may earn rebates based on their purchasing activity. The Company estimates and provides allowances for these programs at the time of sale as a reduction to revenue.

The Company also earns revenue from the sale of integrated circuit boards that use the Company's software technology and license fees for allowing certain OEMs the right to use the Company's technology in their products. The license fee is recognized upon shipment of the OEM's product to its customers, as represented to the Company by the OEM.

***Product Warranty***

The Company provides a warranty against defects in material and workmanship for a period ranging from six months to one year, depending on the product type. In the case of long-term sales agreements, the Company typically warrants the products for the term of the agreement, which ranges from three to six years. In traditional sales activities, including direct and OEM sales, the Company establishes an accrual for the estimated costs of warranty at the time of revenue recognition. Estimated warranty expenses are recorded as an accrued liability, with a corresponding provision to cost of sales. In long-term sales agreements, revenue related to extended warranty is recognized over the life of the contract, while the product warranty costs related to the long-term sales agreements are expensed as incurred.

Changes in the product warranty accrual were as follows (in thousands):

**Nine Months Ended**



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|                                       | September 29,<br>2012 | October 1,<br>2011 |
|---------------------------------------|-----------------------|--------------------|
| Warranty accrual, beginning of period | \$ 698                | \$ 544             |
| Provision for warranty costs          | 1,866                 | 1,919              |
| Warranty expenditures                 | (1,790)               | (1,823)            |
| Warranty accrual, end of period       | \$ 774                | \$ 640             |

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****Comprehensive Income**

Authoritative accounting guidance establishes requirements for reporting and disclosure of comprehensive income and its components. Comprehensive income includes foreign currency translation adjustments that have been excluded from net income including noncontrolling interest and reflected in Masimo Corporation stockholders' equity.

**Net Income Per Share**

Basic net income per share attributable to Masimo Corporation for the three and nine months ended September 29, 2012 and October 1, 2011 is computed by dividing net income attributable to Masimo Corporation stockholders by the weighted average number of shares outstanding during each period. The diluted net income per share attributable to Masimo Corporation stockholders for the three and nine months ended September 29, 2012 and October 1, 2011 is computed by dividing the net income attributable to Masimo Corporation stockholders by the weighted average number of shares and potential shares outstanding during each period, if the effect of potential shares is dilutive. Potential shares include incremental shares of stock issuable upon the exercise of stock options. For the three and nine months ended September 29, 2012, options to purchase 6.4 million and 6.4 million shares of common stock, respectively, were outstanding but were not included in the computation of diluted net income per share because the effect of including such shares would have been antidilutive in the periods presented. For the three and nine months ended October 1, 2011, options to purchase 5.0 million and 4.1 million shares of common stock, respectively, were outstanding but were not included in the computation of diluted net income per share because the effect of including such shares would have been antidilutive in the periods presented. Based on authoritative accounting guidance, the Company reduced its net income including noncontrolling interest by the amount of net (income) loss attributable to noncontrolling interest for the three and nine months ended September 29, 2012 and October 1, 2011. A reconciliation of basic and diluted net income per share attributable to Masimo Corporation stockholders is as follows (in thousands, except per share amounts):

|   | <b>Three Months Ended</b>     |                            | <b>Nine Months Ended</b>      |                            |
|---|-------------------------------|----------------------------|-------------------------------|----------------------------|
|   | <b>September 29,<br/>2012</b> | <b>October 1,<br/>2011</b> | <b>September 29,<br/>2012</b> | <b>October 1,<br/>2011</b> |
| <b>Net income attributable to stockholders of Masimo Corporation:</b> |                               |                            |                               |                            |
| Net income including noncontrolling interest                          | \$ 13,563                     | \$ 14,824                  | \$ 47,097                     | \$ 49,887                  |
| Net (income) loss attributable to the noncontrolling interest         | 231                           | 5                          | 168                           | (7)                        |
| Net income attributable to Masimo Corporation stockholders            | \$ 13,794                     | \$ 14,829                  | \$ 47,265                     | \$ 49,880                  |

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(unaudited)

|  | Three Months Ended    |                    | Nine Months Ended     |                    |
|--|-----------------------|--------------------|-----------------------|--------------------|
|  | September 29,<br>2012 | October 1,<br>2011 | September 29,<br>2012 | October 1,<br>2011 |
| <b>Basic net income per share attributable to Masimo Corporation stockholders:</b>   |                       |                    |                       |                    |
| Net income attributable to Masimo Corporation stockholders                           | \$ 13,794             | \$ 14,829          | \$ 47,265             | \$ 49,880          |
| Weighted average shares outstanding - basic  | 57,201                | 59,971             | 57,507                | 59,804             |
| <b>Basic net income per share attributable to Masimo Corporation stockholders</b>    | <b>\$ 0.24</b>        | <b>\$ 0.25</b>     | <b>\$ 0.82</b>        | <b>\$ 0.83</b>     |
| <b>Diluted net income per share attributable to Masimo Corporation stockholders:</b> |                       |                    |                       |                    |
| Weighted average shares outstanding - basic  | 57,201                | 59,971             | 57,507                | 59,804             |
| Diluted share equivalent: stock options  | 944                   | 1,115              | 947                   | 1,278              |
| Weighted average shares outstanding - diluted  | 58,145                | 61,086             | 58,454                | 61,082             |
| <b>Diluted net income per share attributable to Masimo Corporation stockholders</b>  | <b>\$ 0.24</b>        | <b>\$ 0.24</b>     | <b>\$ 0.81</b>        | <b>\$ 0.82</b>     |

***New Accounting Pronouncement***

In July 2012, the FASB issued Accounting Standards Update No. 2012-02, or ASU 12-02, *Intangibles - Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment*, to allow entities to use a qualitative approach to test indefinite-lived intangible assets for impairment. ASU 12-02 permits an entity to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, then a quantitative impairment test that exists under current authoritative accounting guidance must be completed. Otherwise, the quantitative impairment test is not required. ASU 12-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption of this update is permitted. The Company does not expect the adoption of this update to have a material impact on its condensed consolidated financial statements.

**3. Variable Interest Entity (VIE)**

The Company follows authoritative guidance for the consolidation of its VIE, which requires an enterprise to determine whether its variable interest gives it a controlling financial interest in a VIE. Determination about whether an enterprise should consolidate a VIE is required to be evaluated continuously as changes to existing relationships or future transactions may result in consolidating or deconsolidating the VIE.

***Cercacor Laboratories, Inc.***

Cercacor Laboratories, Inc., or Cercacor, is an independent entity spun off from the Company to its stockholders in 1998. Joe Kiani and Jack Lasersohn, members of the Company's board of directors, or the Board, are also members of the board of directors of Cercacor. Joe Kiani, the Company's Chairman and Chief Executive Officer, is also the Chairman and Chief Executive Officer of Cercacor. The Company is a party to a Cross-Licensing Agreement with Cercacor, which was most recently amended and restated effective January 1, 2007, that governs each party's rights to certain intellectual property held by the two companies.

Under the Cross-Licensing Agreement, the Company granted Cercacor an exclusive, perpetual and worldwide license, with sublicense rights, to use all Masimo SET owned by the Company, including all improvements on this technology, for the monitoring of non-vital signs measurements and to develop and sell devices incorporating Masimo SET for monitoring non-vital signs measurements in any product market in which a product is intended to be used by a patient or pharmacist rather than a professional medical caregiver. The Company refers to this market as the

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Cercacor Market. The Company also granted Cercacor a non-exclusive, perpetual and worldwide license, with sublicense rights to use all Masimo SET for the measurement of vital signs in the Cercacor Market.

The Company exclusively licenses from Cercacor the right to make and distribute products in the professional medical caregiver markets, which the Company refers to as the Masimo Market, that utilize rainbow<sup>®</sup> technology for the measurement

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**MASIMO CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

of carbon monoxide, methemoglobin, fractional arterial oxygen saturation, and total hemoglobin, which includes hematocrit. To date, the Company has developed and commercially released devices that measure carbon monoxide, methemoglobin and total hemoglobin using licensed rainbow<sup>®</sup> technology. The Company also has the option to obtain the exclusive license to make and distribute products that utilize rainbow<sup>®</sup> technology for the monitoring of other non-vital signs measurements, including blood glucose, in product markets where the product is intended to be used by a professional medical caregiver.

From May 1998 through May 2009, Cercacor contracted the services of the Company's employees for the development of rainbow<sup>®</sup> technology. The Company paid Cercacor for the option to market and develop products based on Cercacor technology in defined markets. Through December 2005, the Company paid Cercacor \$7.5 million in option fees. Nearly all these option fees were used by Cercacor to repay the Company for the services that the Company had provided to Cercacor. In addition, through September 2009, the Company exercised its options to three licenses, for \$2.5 million each, for the right to market products based on the new carbon monoxide, methemoglobin and total hemoglobin parameter technologies developed by Cercacor. Effective as of January 1, 2007, the Company entered into a Services Agreement with Cercacor to govern the general and administrative services the Company provides to Cercacor.

The Company's license to rainbow<sup>®</sup> technology for these parameters in these markets is exclusive on the condition that the Company continues to pay Cercacor royalties on its products incorporating rainbow<sup>®</sup> technology, subject to certain minimum aggregate royalty thresholds, and that the Company use commercially reasonable efforts to develop or market products incorporating the licensed rainbow<sup>®</sup> technology. The royalty is up to 10% of the rainbow<sup>®</sup> royalty base, which includes handhelds, tabletop and multi-parameter devices. Handheld products incorporating rainbow<sup>®</sup> technology will carry a 10% royalty rate. For other products, only the proportional amount attributable to that portion of the Company's products used to monitor non-vital signs measurements, sensors and accessories, rather than for monitoring vital signs measurements, will be included in the 10% rainbow<sup>®</sup> royalty base. Effective January 2009, for multi-parameter devices, the rainbow<sup>®</sup> royalty base will include the percentage of the revenue based on the number of rainbow<sup>®</sup> enabled measurements. For hospital contracts where the Company places equipment and enters into a sensor contract, the Company pays a royalty to Cercacor on the total sensor contract revenues based on the ratio of rainbow<sup>®</sup> enabled devices to total devices.

The Company is also subject to certain specific annual minimum aggregate royalty payments. The aggregate royalty payments were \$1.3 million and \$3.8 million for the three and nine months ended September 29, 2012, respectively, and \$1.3 million and \$3.8 million for the three and nine months ended October 1, 2011, respectively. In addition, in connection with a change in control, as defined in the Cross-Licensing Agreement, the minimum aggregate annual royalties for all licensed rainbow<sup>®</sup> measurements payable to Cercacor will increase to \$15.0 million per year for 2012 and thereafter and up to \$2.0 million per year for other rainbow<sup>®</sup> measurements.

In February 2009, in order to accelerate the product development of an improved total hemoglobin spot-check measurement device, Pronto-7, the Company's Board of Directors agreed to fund additional Cercacor engineering expenses. Specifically, these expenses included third party engineering materials and supplies expense as well as 50% of Cercacor's total engineering and engineering related payroll expenses, from April 2009 through June 2010, the original anticipated completion date of this product development effort. Since July 2010, Cercacor has continued to assist the Company with product development efforts and charged the Company accordingly. Beginning in 2012, due to a revised estimate of the support required by the Company to complete the various Pronto-7 related projects, the Company's Board of Directors approved an increase in the percentage of Cercacor's total engineering and engineering related payroll expenses funded by the Company from 50% to 60%. During the nine months ended September 29, 2012, and until both parties agree to end these services, Cercacor assisted and will continue to assist the Company with continuing productization efforts of the new handheld noninvasive multi-parameter spot-check hemoglobin testing device. During the three and nine months ended September 29, 2012, the expenses for these additional services, material and supplies totaled \$1.0 million and \$2.6 million, respectively. During the three and nine months ended October 1, 2011, the expenses for these additional services, material and supplies totaled \$0.5 million and \$1.9 million, respectively.

The condensed consolidated balance sheets include a noncontrolling interest in Cercacor of \$2.7 million and \$2.8 million as of September 29, 2012 and December 31, 2011, respectively, which represents the value of common stock, additional paid in capital and retained earnings of Cercacor, which are not available to the Company. In addition, the condensed consolidated balance sheets include, net of intercompany eliminations, total assets of \$8.6 million and \$6.0 million as of September 29, 2012 and December 31, 2011, respectively, related to Cercacor. Cercacor's total assets as of September 29, 2012 included \$4.1 million for intangible assets, \$2.2 million for property and equipment and \$1.4

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million related to deferred tax assets. Its total assets as of December 31, 2011 included \$2.5 million for intangible assets, \$1.4 million related to deferred tax assets and \$1.2 million for property and equipment. The condensed consolidated balance sheets include total liabilities, net of intercompany eliminations, of \$2.2 million and \$1.2 million as of September 29, 2012 and December 31, 2011, respectively, related to Cercacor.

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Pursuant to authoritative accounting guidance, Cercacor is consolidated within the Company's financial statements for all periods presented. The Company was required to consolidate Cercacor since the Company was deemed to be the primary beneficiary of Cercacor's activities. This determination was based on the Company's significant influence over the operations and decision making of Cercacor. Accordingly, all intercompany royalties, option and license fees and other charges between the Company and Cercacor as well as all intercompany payables and receivables have been eliminated in the consolidation. Also, all direct engineering expenses that have been incurred by the Company and charged to Cercacor have not been eliminated and are included as research and development expense in the Company's condensed consolidated statements of comprehensive income. Upon consolidation, \$2.0 million and \$2.9 million of receivables due from the Company as of September 29, 2012 and December 31, 2011, respectively, were eliminated. Also upon consolidation, \$5.0 million and \$5.3 million of deferred revenue related to technology licensed to the Company as of September 29, 2012 and December 31, 2011, respectively, were eliminated. Assets of Cercacor can only be used to settle obligations of Cercacor and creditors of Cercacor have no recourse to the general credit of the Company.

For the foreseeable future, the Company anticipates that it will continue to consolidate Cercacor pursuant to the current authoritative accounting guidance; however, in the event that Cercacor is no longer considered a VIE or in the event that the Company is no longer the primary beneficiary of Cercacor, the Company may discontinue consolidating the entity.

The changes in noncontrolling interest for Cercacor are as follows (in thousands):

|  | <b>Nine Months<br/>Ended<br/>September 29, 2012</b> |
|--|---|
| Noncontrolling interest, beginning of period                       | \$ 2,838  |
| Increase in additional paid-in capital of noncontrolling interest  | 60  |
| Net loss attributable to noncontrolling interest                   | (168)   |
| Other comprehensive income attributable to noncontrolling interest |   |
| Noncontrolling interest, end of period                             | \$ 2,730  |

**4. Acquisitions*****Spire Semiconductor***

On March 9, 2012, the Company acquired substantially all of the assets and certain liabilities of Spire Semiconductor, LLC, or Spire, a maker of advanced light emitting diode and other advanced component-level technologies. Masimo Semiconductor, Inc., or Masimo Semiconductor, a recently formed, wholly-owned subsidiary of Masimo Corporation, will operate the business going forward. The acquisition gives Masimo an advanced ability to develop custom components, accelerate development cycles, and optimize future product costs. Masimo Semiconductor, based in New Hampshire, will specialize in wafer epitaxy, foundry services, and device fabrication for biomedical, telecommunications, consumer products and other markets.

Under the acquisition agreement, Masimo agreed to pay \$8.0 million and assume \$0.5 million of Spire's liabilities, subject to adjustments contained in the agreement. Simultaneous with this asset acquisition, the Company entered into a lease agreement with a related party to Spire Corporation, to lease manufacturing and office space in New Hampshire through March 2017.

All the assets and liabilities acquired from Spire as of March 9, 2012, and Masimo Semiconductor's operating results from March 10, 2012 through September 29, 2012 are included in these condensed consolidated financial statements. Pro forma results of operations for this

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acquisition have not been presented because the effect of this acquisition was not material to the Company's financial condition or results of operations.

### *Phasein*

On July 27, 2012, the Company acquired Phasein, a developer and manufacturer of ultra-compact mainstream and sidestream capnography, multigas analyzers and handheld capnometry solutions. The acquisition of Phasein's multigas technologies complements the Company's breakthrough innovations for patient monitoring with a portfolio of products ranging from OEM solutions for external plug-in-and-measure gas analyzers and integrated modules to handheld devices. With multiple measurements delivered through either mainstream or sidestream options, the Company's customers can now benefit from CO<sub>2</sub>, N<sub>2</sub>O, O<sub>2</sub>, and anesthetic agent monitoring in many hospital environments, such as operating rooms, procedural sedations and intensive care units.



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The Company paid \$30.5 million for all outstanding shares of Phasein. The final purchase price allocation resulted in \$16.1 million assigned to goodwill, \$12.6 million assigned to intangible assets, \$1.4 million assigned to inventory, \$2.4 million assigned to various other assets and \$2.0 million assigned to various liabilities. The Company funded the acquisition entirely with existing cash and cash equivalents. Phasein's assets acquired and liabilities assumed, as well as its results of operations since the acquisition date, are included in these condensed consolidated financial statements as of September 29, 2012. Pro forma financial information for this acquisition has not been presented because the effect of this acquisition was not material to the Company's consolidated financial statements.

**5. Cash and Cash Equivalents**

The Company considers all highly liquid investments with an original maturity from date of purchase of three months or less, or highly liquid investments that are readily convertible into known amounts of cash, to be cash equivalents. As of September 29, 2012, the Company's cash balance was \$43.4 million, which was comprised of checking accounts. Additionally, the Company had cash equivalents of \$69.6 million, consisting of \$68.0 million of U.S. Treasury bills with a maturity of three months or less at the date of purchase, and \$1.6 million of money market funds. As of December 31, 2011, the Company's cash balance was \$60.8 million, comprised of checking accounts. Additionally, the Company had cash equivalents of \$69.1 million, consisting of \$67.8 million of U.S. Treasury bills and \$1.3 million of money market funds.

**6. Royalties Receivable**

The royalty receivable of \$7.2 million as of September 29, 2012 represents the Company's estimated amount due for the three months ended September 29, 2012. Pursuant to the settlement agreement with Nellcor Puritan Bennett, Inc. (currently Covidien Ltd., or Covidien), the royalties are paid to the Company based on a percentage of sales of Covidien U.S. based pulse oximetry products. The Company recognizes royalty revenue based on the royalty rate per the settlement agreement multiplied by its estimate of Covidien's sales for each quarter. Any adjustments to the quarterly estimate are recorded prospectively in the following quarter, when the Company receives the Covidien royalty report and payment, which is generally 60 days after the end of each of Covidien's fiscal quarters.

On January 28, 2011, the Company entered into a second amendment to its settlement agreement with Covidien. As part of this amendment, which became effective on March 15, 2011, Covidien has agreed to pay the Company a royalty at a rate of 7.75% of its United States pulse oximetry revenue, as that term is defined in the January 28, 2011 second amendment, at least through March 15, 2014. In exchange for this royalty payment, the Company has provided Covidien with a covenant not to sue for its current pulse oximetry products, but not for any other technologies that Covidien may add, pursuant to the second amendment.

**7. Inventories**

Inventories are stated at the lower of cost or market. Cost is determined using a standard cost method, which approximates FIFO (first-in, first-out) and includes material, labor and overhead. Inventory valuation allowances are recorded for materials that have become obsolete or are no longer used in current production and for inventory that has a market value less than the carrying value in inventory. Inventories consist of the following (in thousands):

|                 | September 29,<br>2012 | December 31,<br>2011 |
|-----------------|-----------------------|----------------------|
| Raw materials   | \$ 23,450             | \$ 25,444            |
| Work in-process | 5,041                 | 4,851                |
| Finished goods  | 20,490                | 15,649               |
| Total           | \$ 48,981             | \$ 45,944            |

## **8. Stock Repurchase Program**

In August 2011, the Company's board of directors authorized the repurchase of up to 3.0 million shares of the Company's common stock under a repurchase program, which was terminated pursuant to its terms in April 2012. The stock repurchase program was carried out at the discretion of a committee comprised of the Company's Chief Executive Officer and Chief Financial Officer through open market purchases, Rule 10b5-1 trading plans, block trades and in privately negotiated transactions. During the year ended December 31, 2011, 1.8 million shares were repurchased, at an average price of \$19.61 per share, totaling \$36.2 million. During the nine months ended September 29, 2012, 1.2 million shares were repurchased, at an average price of \$22.74 per share, totaling \$26.3 million. No shares were repurchased during the three months ended September 29, 2012.

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****9. Share-Based Compensation**

On August 7, 2007, in connection with the Company's initial public offering, the 2007 Stock Incentive Plan, or the 2007 Plan, became effective. Under the 2007 Plan, 3.0 million shares of common stock were initially reserved for future issuance, plus shares available under the prior year equity incentive plans and shares that become available under the 2007 Plan due to forfeitures at prices not less than the fair market value of the Company's common stock on the date the option is granted. The options generally vest annually over five years using the straight-line method, unless otherwise provided, and expire ten years from the date of grant. Options forfeited under any of the Company's stock incentive plans are automatically added to the share reserve of the 2007 Plan. Pursuant to the evergreen provision contained in the 2007 Plan, an additional 1.7 million shares of common stock were added to the share reserve of the 2007 Plan on January 1, 2012, which represented 3% of the Company's total shares outstanding as of December 31, 2011. Subject to applicable laws, the Company may terminate the 2007 Plan at any time. If not terminated sooner, the 2007 Plan will automatically terminate on August 7, 2017.

During the fiscal year ended December 31, 2011, the Company issued 629,000 shares of common stock as a result of stock option exercises. The number and weighted average exercise price of options issued and outstanding under all stock option plans are as follows (in thousands, except for exercise prices):

|  | <b>Nine Months Ended<br/>September 29, 2012</b> |                                       |
|--|---|---------------------------------------|
|  | <b>Shares</b>                                   | <b>Average<br/>Exercise<br/>Price</b> |
| Options outstanding, beginning of period   | 8,277   | \$ 22.68                              |
| Granted                                    | 543   | \$ 22.36                              |
| Canceled                                   | (310)   | \$ 27.08                              |
| Exercised                                  | (140)   | \$ 7.39                               |
| Options outstanding, end of period         | 8,370   | \$ 22.76                              |
| Options exercisable, end of period         | 4,442   | \$ 21.14                              |
| Options available for grant, end of period | 5,008   |                                       |

The Black-Scholes option pricing model is used to estimate the fair value of options granted under the Company's share-based compensation plans. The range of assumptions used and the resulting weighted-average fair value of options granted at the date of grant were as follows:

|  | <b>Three Months Ended</b>     |                            | <b>Nine Months Ended</b>      |                            |
|--|-------------------------------|----------------------------|-------------------------------|----------------------------|
|  | <b>September 29,<br/>2012</b> | <b>October 1,<br/>2011</b> | <b>September 29,<br/>2012</b> | <b>October 1,<br/>2011</b> |
| Risk-free interest rate                        | 0.7% to 1.0%                  | 1.0% to 1.9%               | 0.7% to 1.3%                  | 1.0% to 2.5%               |
| Expected term                                  | 5.5 years                     | 5.3 years                  | 5.5 years                     | 5.3 years                  |
| Estimated volatility                           | 36.8% to 37.8%                | 36.7% to 41.8%             | 36.8% to 42.6%                | 36.7% to 41.8%             |
| Expected dividends                             | 0%                            | 0%                         | 0%                            | 0%                         |
| Weighted-average fair value of options granted | \$8.41                        | \$10.34                    | \$8.10                        | \$11.50                    |

The total share-based compensation expense for the three and nine months ended September 29, 2012 was \$3.2 million and \$11.0 million, respectively. The total share-based compensation expense for the three and nine months ended October 1, 2011 was \$2.6 million and \$10.2

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million, respectively. The aggregate intrinsic value of options outstanding, with an exercise price less than the closing price of the Company's common stock, as of September 29, 2012 was \$32.7 million. The aggregate intrinsic value of options exercisable, with an exercise price less than the closing price of the Company's common stock, as of September 29, 2012 was \$26.3 million. The aggregate intrinsic value of options exercised during the three and nine months ended September 29, 2012, was \$1.2 million and \$2.1 million, respectively. The aggregate intrinsic value is calculated as the difference between the market value of the Company's common stock on the date of exercise or the respective period end, as appropriate, and the exercise price of the options. The unrecognized share-based compensation as of September 29, 2012 was \$31.2 million related to unvested options granted after January 1, 2006. The weighted average remaining contractual term of options outstanding as of September 29, 2012 was 6.5 years. The weighted average remaining contractual term of options exercisable as of September 29, 2012 was 4.1 years.

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The Company leases its facilities in North America, Europe and Asia under operating lease agreements expiring at various dates through March 2017. Certain facilities leases contain predetermined price escalations and in some cases renewal options. The Company recognizes the lease costs using a straight line method based on total lease payments. The Company also received certain leasehold improvement incentives totaling \$0.7 million for its headquarters facilities in the U.S. These leasehold improvement incentives have been recorded as deferred rent and are being amortized as a reduction to rent expense on a straight-line basis over the life of the lease. As of September 29, 2012 and December 31, 2011, rent expense accrued in excess of the amount paid aggregated \$0.8 million and \$0.3 million, respectively, and is classified in other liabilities in the accompanying consolidated balance sheets. The Company also leases automobiles in Europe that are classified as operating leases and expire at various dates through June 2015. The majority of these leases are non-cancelable. The Company also has capital leases outstanding for office equipment all of which are non-cancelable.

Future minimum lease payments under operating and capital leases for each of the following fiscal years ending on or about December 31 are (in thousands):

|                        | As of September 29, 2012 |                   |                  |
|------------------------|--------------------------|-------------------|------------------|
|                        | Operating<br>Leases      | Capital<br>Leases | Total            |
| 2012 (balance of year) | \$ 1,394                 | \$ 16             | \$ 1,410         |
| 2013                   | 5,058                    | 59                | 5,117            |
| 2014                   | 3,712                    | 26                | 3,738            |
| 2015                   | 1,956                    | 10                | 1,966            |
| 2016                   | 1,725                    | 10                | 1,735            |
| Thereafter             | 345                      | 8                 | 353              |
| <b>Total</b>           | <b>\$ 14,190</b>         | <b>\$ 129</b>     | <b>\$ 14,319</b> |

Rental expense related to operating leases was \$1.2 million and \$3.3 million for the three and nine months ended September 29, 2012, respectively, and \$1.0 million and \$2.8 million for the three and nine months ended October 1, 2011, respectively. The Company currently has five capital leases related to office equipment. These leases have interest rates ranging from 4.5% to 6.6% per year and mature on various dates from December 2012 through October 2017.

**Employee Retirement Savings Plan**

In fiscal year 1996, the Company adopted the Masimo Retirement Savings Plan, or the Plan, which is a 401(k) plan covering all of the Company's full-time U.S. employees who meet certain eligibility requirements. In general, the Company matches 100% of an employee's contribution up to 3% of the employee's compensation, subject to a maximum amount. The Company may also contribute to the Plan on a discretionary basis. The Company contributed \$0.4 million and \$1.0 million to the Plan for the three and nine months ended September 29, 2012, respectively, and \$0.3 million and \$0.9 million to the Plan for the three and nine months ended October 1, 2011, respectively.

**Employment and Severance Agreements**

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As of September 29, 2012, the Company had an employment agreement with one of its key employees that provides for an aggregate annual base salary with annual increases at the discretion of the Compensation Committee of the board. The employment agreement provides for an annual bonus based on the Company's attainment of certain objectives and goals. The agreement has an initial term of three years, with automatic daily renewal, unless either the Company or the executive notifies the other party of non-renewal of the agreement. Also, under this employment agreement, the key employee may be entitled to receive certain salary, equity, tax, medical and life insurance benefits if he is terminated by the Company, if he terminates his employment for good reason under certain circumstances or if there is a change in control of the Company.

As of September 29, 2012, the Company had severance plan participation agreements with three of its executive officers. The participation agreements, or Agreements, are governed by the terms and conditions of the Company's 2007 Severance Protection Plan, or Severance Plan, which became effective on July 19, 2007 and was amended effective December 31, 2008. Under the Agreements, each executive officer may be entitled to receive certain salary, equity, medical and life insurance benefits if he is terminated by the Company without cause or terminates his employment for good reason under certain circumstances. The executive officers are also required to give the Company six months advance notice of their resignation under certain circumstances.

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**MASIMO CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

As of September 29, 2012, the Company had limited severance plan participation agreements with three of its executive officers. These limited participation agreements, or Limited Agreements, are governed by the terms and conditions of the Severance Plan. Under the Limited Agreements, 50% of the executive officer's unvested and outstanding stock options will immediately vest if the executive officer is terminated by the Company upon a change in control under certain circumstances. The executive officers are also required to give the Company six months advance notice of their resignation under certain circumstances.

***Purchase Commitments***

Pursuant to contractual obligations with vendors, the Company had \$41.5 million of purchase commitments as of September 29, 2012, which are expected to be purchased within one year. These purchase commitments were made for certain inventory items to secure better pricing and to ensure the Company will have raw materials when necessary.

***Concentrations of Risk***

The Company is exposed to credit loss for the amount of cash deposits with financial institutions in excess of federally insured limits. The Company invests its excess cash deposits in U.S. Treasury bills and money market accounts with major financial institutions. As of September 29, 2012, the Company had \$43.4 million of bank balances, of which \$20.3 million was covered by either the U.S. Federal Deposit Insurance Corporation limit or foreign countries' deposit insurance organizations. As of December 31, 2011, the Company had \$60.8 million of bank balances, of which \$25.7 million was covered by either the U.S. Federal Deposit Insurance Corporation limit or foreign countries' deposit insurance organizations.

While the Company and its contract manufacturers rely on sole source suppliers for certain components, steps have been taken to minimize the impact of a shortage or stoppage of shipments, such as maintaining a safety stock of inventory and designing products that may be easily modified to use a different component. However, there can be no assurance that a shortage or stoppage of shipments of the materials or components that the Company purchases will not result in a delay in production, or adversely affect the Company's business.

The Company's ability to sell its products to U.S. hospitals depends in part on its relationships with GPOs. Many existing and potential customers for the Company's products become members of GPOs. GPOs negotiate pricing arrangements and contracts, sometimes exclusively, with medical supply manufacturers and distributors, and these negotiated prices are made available to a GPO's affiliated hospitals and other members. During the three and nine months ended September 29, 2012, revenue from the sale of the Company's products to U.S. hospitals that are members of GPOs amounted to \$62.3 million and \$188.0 million, respectively. During the three and nine months ended October 1, 2011, revenue from the sale of the Company's pulse oximetry products to U.S. hospitals that are members of GPOs amounted to \$55.2 million and \$166.7 million, respectively.

As of September 29, 2012, two different just-in-time distributors each represented 10% and 9% of the accounts receivable balance. As of December 31, 2011, one just-in-time distributor represented 5% of the accounts receivable balance.

For the three months ended September 29, 2012, the Company had sales through two just-in-time distributors, which each represented 15% and 11% of the total revenue, respectively. For the nine months ended September 29, 2012, the Company also had sales through two just-in-time distributors, which also each represented 14% and 12% of the total revenue, respectively. For the three months ended October 1, 2011, the Company had sales through two just-in-time distributors, each of which represented 14% and 10% of the total revenue, respectively. For the nine months ended October 1, 2011, the Company had sales through two just-in-time distributors, each of which represented 14% and 10% of the total revenue, respectively. For both periods, the just-in-time distributors took and fulfilled orders from the Company's direct customers, many of whom have signed long-term sensor agreements with the Company.

***Litigation***

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On February 3, 2009, the Company filed a patent infringement suit against Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH related to Philips' FAST pulse oximetry technology and certain of Philips patient monitors. The suit was brought in the U.S. District Court for the District of Delaware. Two patents originally asserted in this suit, related to the Company's measure-through motion technology, were successfully enforced in the Company's previous suit against Nellcor. On June 15, 2009, Philips Electronics North America Corporation and Philips Medizin Systeme



**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Böblingen GmbH answered the Company's complaint and Philips Electronics North America Corporation filed antitrust and patent infringement counterclaims against the Company as well as counterclaims seeking declaratory judgments of invalidity on the patents asserted by the Company against Philips. On July 9, 2009, the Company filed its answer denying Philips' counterclaims and asserting various defenses. The Company also asserted counterclaims against Philips for fraud, intentional interference with prospective economic advantage and for declaratory judgments of noninfringement and invalidity with respect to the patents asserted by Philips against the Company. Philips later added a claim for infringement of one additional patent. Subsequently, the Court bifurcated Philips' antitrust claims and its patent misuse defense, as well as stayed the discovery phase on those claims pending trial in the patent case. On October 4, 2010, the Court limited the number of patents to be construed to four for the Company and three for Philips. Further, on October 6, 2010, the Court denied Philips' motion to bifurcate and stay damages in the patent case. In December 2010, the Court held a hearing regarding the construction of the patent claims and the Magistrate Judge issued a Report and Recommendation on claim construction on February 18, 2011. On January 17, 2012, the District Court Judge issued a claim construction order, adopting the Report and Recommendation of the Magistrate Judge, except with respect to one construction on one of the Company's patents to which it had objected. With respect to this one claim construction, the District Court Judge did not adopt the recommendation from the Magistrate Judge and adopted the construction proposed by the Company. The Company believes that it has good and substantial defenses to the antitrust and patent infringement claims asserted by Philips. There is no guarantee that the Company will prevail in this suit or receive any damages or other relief if it does prevail.

From time to time, the Company may be involved in other litigation relating to claims arising out of its operations in the normal course of business. The Company believes that it currently is not a party to any other legal proceedings which, individually or in the aggregate, would have a material adverse effect on its consolidated financial position, results of operations or cash flows.

**11. Segment Information and Enterprise Reporting**

The Company's chief decision maker, the Chief Executive Officer, reviews financial information presented on a consolidated basis, accompanied by disaggregated information about revenues by geographic region for purposes of making operating decisions and assessing financial performance. Accordingly, the Company considers itself to be in a single reporting segment, specifically noninvasive patient monitoring solutions and related products. The Company does not assess the performance of its geographic regions on other measures of income or expense, such as depreciation and amortization, operating income or net income including noncontrolling interest. In addition, the Company's assets are primarily located in the U.S. The Company does not produce reports for, or measure the performance of, its geographic regions on any asset-based metrics. Therefore, geographic information is presented only for revenues.

The following schedule presents an analysis of the Company's product revenues based upon the geographic area to which the product was shipped (in thousands, except percentages):

| <b>Geographic Area by Destination</b> | <b>Three Months Ended</b> |       |                        |       | <b>Nine Months Ended</b>  |       |                        |       |
|---------------------------------------|---------------------------|-------|------------------------|-------|---------------------------|-------|------------------------|-------|
|                                       | <b>September 29, 2012</b> |       | <b>October 1, 2011</b> |       | <b>September 29, 2012</b> |       | <b>October 1, 2011</b> |       |
| North and South America               | \$ 82,656                 | 73.7% | \$ 73,295              | 75.1% | \$ 253,472                | 74.6% | \$ 225,311             | 74.7% |
| Europe, Middle East and Africa        | 15,691                    | 14.0  | 12,947                 | 13.2  | 47,983                    | 14.1  | 42,906                 | 14.2  |

**Table of Contents****MASIMO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(unaudited)

|                       | Three Months Ended |      |                 |      | Nine Months Ended  |      |                 |      |
|-----------------------|--------------------|------|-----------------|------|--------------------|------|-----------------|------|
|                       | September 29, 2012 |      | October 1, 2011 |      | September 29, 2012 |      | October 1, 2011 |      |
| Asia and Australia    | 13,761             | 12.3 | 11,397          | 11.7 | 38,189             | 11.3 | 33,554          | 11.1 |
| Total product revenue | \$ 112,108         | 100% | \$ 97,639       | 100% | \$ 339,644         | 100% | \$ 301,771      | 100% |
| United States         | \$ 79,222          |      | \$ 70,343       |      | \$ 243,165         |      | \$ 214,216      |      |

**12. Income Taxes**

As of September 29, 2012, the balance of the gross unrecognized tax benefit was \$6.6 million, of which \$5.6 million (net of federal benefit on state taxes), if recognized, would affect the effective tax rate. As of December 31, 2011, the balance of the gross unrecognized tax benefit was \$8.4 million, of which \$7.4 million (net of federal benefit on state taxes), if recognized, would affect the effective tax rate. The remaining balance relates to timing differences. It is reasonably possible that the amount of unrecognized tax benefits in various jurisdictions may change in the next twelve months due to the expiration of statutes of limitation and audit settlements. However, due to the uncertainty surrounding the timing of these events, an estimate of the change within the next twelve months cannot currently be made.

Interest and penalties related to unrecognized tax benefits are recognized in income tax expense. For the three and nine months ended September 29, 2012, the Company expensed \$0 and \$0.1 million, respectively, for interest. For the three and nine months ended October 1, 2011, the Company expensed \$0.1 million and \$0.2 million, respectively, for interest.

The Company conducts business in multiple jurisdictions, and as a result, one or more of the Company's subsidiaries files income tax returns in the U.S. federal, various state, local and foreign jurisdictions. The Company has concluded all U.S. federal income tax matters for each year through 2007. All material state, local and foreign income tax matters have been concluded for each year through 2004.

The provision for income taxes was \$5.3 million and \$15.7 million, or an effective tax rate of 28.1% and 25.0%, for the three and nine months ended September 29, 2012, respectively. The provision for income taxes was \$3.9 million and \$17.0 million, or an effective tax rate of 20.7% and 25.5%, for the three and nine months ended October 1, 2011, respectively. Included in the provision for income taxes for the three months ended September 29, 2012 is a \$0.4 million income tax benefit related to the derecognition of an uncertain tax position due to the expiration of statutes of limitations. Also, included in the provision for income taxes for the nine months ended September 29, 2012 is a \$2.4 million income tax benefit related to the derecognition of an uncertain tax position resulting from the conclusion of a prior year tax audit. The effective tax rate differs from the statutory U.S. federal income tax rate of 35% primarily due to state taxes, permanent differences between pre-tax income for financial reporting purposes and taxable income, state research related tax credits, the recognition and derecognition of tax benefits related to uncertain tax positions and anticipated income in jurisdictions in which the Company does business with different effective tax rates.

**13. Subsequent Event**

On October 31, 2012, the Company declared a special \$1.00 per share cash dividend, payable on December 11, 2012 to stockholders of record as of the close of business on November 27, 2012. The total dividend payout is expected to be approximately \$57.2 million, based on the current shares outstanding.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This Quarterly Report on Form 10-Q contains forward-looking statements as defined in Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, in connection with the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially and adversely from those expressed or implied by such forward-looking statements. Such forward-looking statements include any expectation of earnings, revenues or other financial items; any statements of the plans, strategies and objectives of management for future operations; factors that may affect our operating results or financial condition; statements concerning new products, technologies or services; statements related to future capital expenditures; statements related to future economic conditions or performance; and statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as anticipate, believe, continue, could, estimate, expect, intend, may, or will, and similar expressions or variations. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially and adversely from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included elsewhere in this Quarterly Report Form 10-Q and in our other Securities and Exchange Commission, or SEC, filings, including our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, which we filed with the SEC on February 17, 2012. Furthermore, such forward-looking statements speak only as of the date of this report. We undertake no obligation to update any forward-looking statements to reflect events or circumstances occurring after the date of such statements.*

**Overview**

We are a global medical technology company that develops, manufactures, and markets noninvasive patient monitoring products. Our mission is to improve patient outcomes and reduce cost of care by taking noninvasive monitoring to new sites and applications. We invented Masimo SET<sup>®</sup>, which provides the capabilities of Measure-Through Motion and Low Perfusion pulse oximetry to address the primary limitations of conventional pulse oximetry. Pulse oximetry is the noninvasive measurement of the oxygen saturation level of arterial blood, or the blood that delivers oxygen to the body's tissues, and pulse rate. Pulse oximetry is one of the most common measurements made in and out of hospitals around the world. Masimo SET<sup>®</sup> has been validated in over 100 independent clinical studies and is the only pulse oximetry technology we are aware of that has been proven to help clinicians detect critical congenital heart disease in newborns, reduce retinopathy of prematurity in neonates, and decrease intensive care unit transfers and rapid response activations on the general floor.

Our products consist of a monitor or circuit board for use with our proprietary single-patient-use and reusable sensors and cables. We sell our products to end-users through our direct sales force and certain distributors, and some of our products to our OEM partners, for incorporation into their products. As of September 29, 2012, we estimate that the worldwide installed base of our pulse oximeters and OEM monitors that incorporate Masimo SET<sup>®</sup> was 1,056,000 units, based on an estimated 10 year field life assumption. Our installed base is the primary driver for the recurring sales of our sensors, most notably, single-patient-use adhesive sensors. Based on industry reports, we estimate that the worldwide pulse oximetry market was over \$1 billion in 2011, the largest component of which was the sale of sensors.

After introducing Masimo SET<sup>®</sup>, we have continued to innovate by introducing breakthrough noninvasive measurements beyond arterial blood oxygen saturation level and pulse rate, which create new market opportunities in both the hospital and non-hospital care settings. In 2005, we launched our Masimo rainbow<sup>®</sup> SET platform utilizing both Masimo SET<sup>®</sup> and licensed rainbow<sup>®</sup> technology, which we believe includes the first devices cleared by the Food and Drug Administration, or FDA, to noninvasively and continuously monitor multiple measurements that previously required invasive or complicated procedures. Also, in 2005, we launched noninvasive carboxyhemoglobin, or SpCO<sup>®</sup>, allowing measurement of carbon monoxide levels in the blood. Carbon monoxide is the most common cause of poisoning in the world. In 2006, we launched noninvasive methemoglobin, or SpMet<sup>®</sup>, allowing for the measurement of methemoglobin levels in the blood. Methemoglobin in the blood leads to a dangerous condition known as methemoglobinemia, which occurs as a reaction to some common drugs used in hospitals and outpatient procedures. In 2007, we launched Masimo Pleth Variability Index, or PVI<sup>®</sup>. Fluid administration is critical to optimizing fluid status in surgery and critical care, but traditional invasive methods to guide fluid administration often fail to predict fluid responsiveness and newer methods are complicated and costly. In March 2008, we debuted noninvasive hemoglobin, or SpHb<sup>®</sup>. In May 2008, we received FDA clearance for SpHb<sup>®</sup>, and in March 2009, we began full market release of SpHb<sup>®</sup>. Hemoglobin is defined as the oxygen-carrying component of red blood cells, and is one of the most frequent invasive laboratory measurements in the world, often measured as part of a complete blood count. A low hemoglobin status is called anemia, which is generally caused by bleeding or the inability of the body to

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produce red blood cells. In November 2009, we received FDA clearance for continuous and noninvasive monitoring of respiration rate, or RRA™, via rainbow Acoustic Monitoring™. Respiration rate is the number of breaths per minute, and often the leading indicator of patient distress. Traditional methods used to measure respiration rate are often considered inaccurate or are not tolerated well by patients. In June 2010, we began a full commercial release of RRA™. In July 2010, we began selling the SEDLine® monitor, which measures brain function on a continuous basis and provides information about a patient's response to anesthesia. In January 2012, we received FDA clearance for the Pronto-7®, a product designed specifically for spot-checking hemoglobin, along with oxygen saturation and pulse rate. In October 2010, we debuted the Halo Index™, which allows continuous global trending and assessment of multiple physiological measurements of a patient with a single number displayed on the SafetyNet™ screen. Halo Index™ is pending FDA 510(k) clearance. In October 2012, we received the CE Mark and debuted the new fractional arterial oxygen saturation, SpfO<sub>2</sub>, parameter through the rainbow® Universal ReSposable SuperSensor. Both SpfO<sub>2</sub> and the rainbow® Universal ReSposable SuperSensor are pending 510(k) clearance.

We also offer a remote monitoring and clinician notification solution called SafetyNet™, which includes our Masimo SET® or rainbow® SET monitors at the patient's bedside along with a central assignment station and wired or wireless server. SafetyNet™ wirelessly notifies clinicians who are taking care of multiple patients in different rooms when one of their patients has an alarm, allowing them to intervene sooner and avoid negative outcomes.

We offer Masimo SET® and rainbow® SET through our OEMs and our own end-user products, including the Radical-7™, Rad-87®, Rad-57™, Pronto®, Pronto-7®, Rad-8®, Rad-5® and Rad-5v™. Our solutions and related products are based upon our proprietary Masimo SET® and rainbow® algorithms. This software-based technology is incorporated into a variety of product platforms depending on our customers' specifications. Our technology is supported by a substantial intellectual property portfolio that we have built through internal development and, to a lesser extent, acquisitions and license agreements. We have exclusively licensed from our development partner, Cercacor Laboratories, Inc., or Cercacor, the right to OEM rainbow® technology and incorporate rainbow® technology into our products intended to be used by professional caregivers, including, but not limited to, hospital caregivers and alternate care market, facility caregivers.

### ***Cercacor Laboratories, Inc.***

Cercacor is an independent entity spun off from us to our stockholders in 1998. Joe Kiani and Jack Lasersohn, members of our board of directors, are also members of the board of directors of Cercacor. Joe Kiani, our Chairman and Chief Executive Officer, is also the Chairman and Chief Executive Officer of Cercacor. We are a party to a cross-licensing agreement with Cercacor, which was amended and restated effective January 1, 2007, or the Cross-Licensing Agreement, that governs each party's rights to certain intellectual property held by the two companies.

Under the Cross-Licensing Agreement, we granted Cercacor an exclusive, perpetual and worldwide license, with sublicense rights to use all Masimo SET owned by us, including all improvements on this technology, for the monitoring of non-vital signs measurements and to develop and sell devices incorporating Masimo SET for monitoring non-vital signs measurements in any product market in which a product is intended to be used by a patient or pharmacist, which we refer to as the Cercacor Market, rather than a professional medical caregiver. We also granted Cercacor a non-exclusive, perpetual and worldwide license, with sublicense rights to use all Masimo SET for the measurement of vital signs in the Cercacor Market.

We exclusively license from Cercacor the right to make and distribute products in the professional medical caregiver markets, which we refer to as the Masimo Market, that utilize rainbow® technology for the measurement of carbon monoxide, methemoglobin, fractional arterial oxygen saturation and total hemoglobin, which includes hematocrit. To date, we have developed and commercially released devices that measure carbon monoxide, methemoglobin and total hemoglobin using licensed rainbow® technology. We also have the option to obtain the exclusive license to make and distribute products that utilize rainbow® technology for the monitoring of other non-vital signs measurements, including blood glucose, in product markets where the product is intended to be used by a professional medical caregiver.

In February 2009, in order to accelerate the product development of our total hemoglobin spot-check measurement device, we agreed to fund additional Cercacor's engineering expenses. Specifically, these expenses included third party engineering materials and supplies expense, as well as 50% of Cercacor's total engineering and engineering related payroll expenses from April 2009 through June 2010, the completion of this product development effort. Since July 2010, Cercacor has continued to assist us with other product development efforts and charged us accordingly. Beginning in 2012, due to a revised estimate of the support required by us to complete the various Pronto-7 related projects, our Board of Directors approved an increase in the percentage of Cercacor's total engineering and engineering related payroll expenses funded by us from 50% to 60%. We expect this arrangement to continue in the future. During the three months ended September 29, 2012, the total funding for Cercacor's additional expenses totaled \$1.0 million. For additional discussion of Cercacor, see Note 3 to the condensed consolidated financial statements.



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For the foreseeable future, we anticipate that we will continue to consolidate Cercacor pursuant to the current authoritative accounting guidance; however, in the event that Cercacor is no longer considered a variable interest entity, or VIE, or in the event that we are no longer the primary beneficiary of Cercacor, we may discontinue consolidating the entity.

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

In August 2011, our board of directors authorized us to repurchase up to 3.0 million shares of our common stock under a repurchase program, which terminated pursuant to its terms in April 2012. The stock repurchase program was carried out at the discretion of a committee comprised of our Chief Executive Officer and Chief Financial Officer through open market purchases, Rule 10b5-1 trading plans, block trades and in privately negotiated transactions. We have paid for prior repurchases of stock with available cash and cash equivalents. During the year ended December 31, 2011, 1.8 million shares were repurchased, at an average price of \$19.61 per share. During the nine months ended September 29, 2012, 1.2 million shares were repurchased, at an average price of \$22.74 per share, totaling \$26.3 million, which completed the stock repurchase program. No shares were repurchased during the three months ended September 29, 2012.

### ***Spire Semiconductor Acquisition***

On March 9, 2012, we acquired substantially all of the assets of Spire Semiconductor, LLC, or Spire, maker of advanced light emitting diode and other advanced component-level technologies. Masimo Semiconductor, Inc., or Masimo Semiconductor, a recently formed, wholly-owned subsidiary of ours, will operate the business going forward. Under the acquisition agreement, we agreed to pay \$8.0 million and assume \$0.5 million of Spire's liabilities, subject to adjustments contained in the agreement. Simultaneous with this asset acquisition, we entered into a lease agreement with a related party to Spire Corporation, to lease manufacturing and office space through March 2017.

The acquisition gives us an advanced ability to develop custom components, accelerate development cycles, and optimize future product costs. Masimo Semiconductor will specialize in wafer epitaxy, foundry services, and device fabrication for biomedical, telecommunications, consumer products and other markets. For additional information, see Note 4 to the condensed consolidated financial statements.

### ***PHASEIN Acquisition***

On July 27, 2012, we acquired PHASEIN AB (Stockholm, Sweden), or Phasein, a developer and manufacturer of ultra-compact mainstream and sidestream capnography, multigas analyzers and handheld capnometry solutions. The acquisition of Phasein's multigas technologies complements our breakthrough innovations for patient monitoring with a portfolio of products ranging from OEM solutions for external plug-in-and-measure gas analyzers and integrated modules to handheld devices. With multiple measurements delivered through either mainstream or sidestream options, our customers can now benefit from CO<sub>2</sub>, N<sub>2</sub>O, O<sub>2</sub>, and anesthetic agent monitoring in many hospital environments, such as operating rooms, procedural sedations and intensive care units.

We paid \$30.5 million for all outstanding shares of Phasein. The final purchase price allocation resulted in \$16.1 million assigned to goodwill, \$12.6 million assigned to intangible assets, \$1.4 million assigned to inventory, \$2.4 million assigned to various other assets and \$2.0 million assigned to various liabilities. Phasein's assets acquired and liabilities assumed, as well as its results of operations since the acquisition date, are included in our condensed consolidated financial statements as of September 29, 2012. We funded the acquisition entirely with existing cash and cash equivalents.

### ***Dividend Declaration***

On October 31, 2012, we declared a special \$1.00 per share cash dividend, payable on December 11, 2012 to stockholders of record as of the close of business on November 27, 2012. The total dividend payout is expected to be approximately \$57.2 million, based on the current shares outstanding.

**Table of Contents****Results of Operations**

The following table sets forth, for the periods indicated, our unaudited results of operations expressed as dollar amounts and as a percentage of total revenues (in thousands, except percentages).

|   | Three Months Ended    |                 |                    |                 | Nine Months Ended     |                 |                    |                 |
|---|-----------------------|-----------------|--------------------|-----------------|-----------------------|-----------------|--------------------|-----------------|
|   | September 29,<br>2012 | % of<br>Revenue | October 1,<br>2011 | % of<br>Revenue | September 29,<br>2012 | % of<br>Revenue | October 1,<br>2011 | % of<br>Revenue |
| <b>Revenue:</b>   |                       |                 |                    |                 |                       |                 |                    |                 |
| Product   | \$ 112,108            | 94.2%           | \$ 97,639          | 93.8%           | \$ 339,644            | 94.1%           | \$ 301,771         | 92.4%           |
| Royalty   | 6,961                 | 5.8             | 6,401              | 6.2             | 21,428                | 5.9             | 24,876             | 7.6             |
| Total revenue   | 119,069               | 100.0           | 104,040            | 100.0           | 361,072               | 100.0           | 326,647            | 100.0           |
| Cost of goods sold  | 40,736                | 34.2            | 35,601             | 34.2            | 122,002               | 33.8            | 106,125            | 32.5            |
| Gross profit  | 78,333                | 65.8            | 68,439             | 65.8            | 239,070               | 66.2            | 220,522            | 67.5            |
| <b>Operating expenses:</b>                                    |                       |                 |                    |                 |                       |                 |                    |                 |
| Selling, general and administrative                           | 48,260                | 40.5            | 40,134             | 38.6            | 142,381               | 39.4            | 125,275            | 38.4            |
| Research and development                                      | 12,121                | 10.2            | 9,372              | 9.0             | 33,736                | 9.4             | 28,793             | 8.8             |
| Total operating expenses                                      | 60,381                | 50.7            | 49,506             | 47.6            | 176,117               | 48.8            | 154,068            | 47.2            |
| Operating income  | 17,952                | 15.1            | 18,933             | 18.2            | 62,953                | 17.4            | 66,454             | 20.3            |
| Non-operating income (expense)                                | 912                   | 0.8             | (240)              | (0.2)           | (132)                 | (0.0)           | 482                | 0.1             |
| Income before provision for income taxes                      | 18,864                | 15.9            | 18,693             | 18.0            | 62,821                | 17.4            | 66,936             | 20.5            |
| Provision for income taxes                                    | 5,301                 | 4.5             | 3,869              | 3.7             | 15,724                | 4.4             | 17,049             | 5.2             |
| Net income including noncontrolling interest                  | 13,563                | 11.4            | 14,824             | 14.3            | 47,097                | 13.0            | 49,887             | 15.3            |
| Net (income) loss attributable to the noncontrolling interest | 231                   | 0.2             | 5                  | 0.0             | 168                   | 0.1             | (7)                | (0.0)           |
| Net income attributable to Masimo Corporation stockholders    | \$ 13,794             | 11.6%           | \$ 14,829          | 14.3%           | \$ 47,265             | 13.1%           | \$ 49,880          | 15.3%           |

**Comparison of the Three Months ended September 29, 2012 to the Three Months ended October 1, 2011**

**Revenue.** Total revenue increased \$15.1 million, or 14.4%, to \$119.1 million for the three months ended September 29, 2012 from \$104.0 million for the three months ended October 1, 2011. Product revenues increased \$14.5 million, or 14.8%, to \$112.1 million in the three months ended September 29, 2012 from \$97.6 million in the three months ended October 1, 2011. This increase was primarily due to higher consumable sales resulting from an increase in our installed base of circuit boards and pulse oximeters, which we estimate totaled 1,056,000 units at September 29, 2012, up from 950,000 units at October 1, 2011. Also, contributing to the increase in our product revenue was our rainbow<sup>®</sup> technology product revenues, which increased \$3.2 million, or 41.3%, to \$11.0 million in the three months ended September 29, 2012 from \$7.8 million in the three months ended October 1, 2011. Product revenue of \$112.1 million during the three months ended September 29, 2012 included \$1.5 million and \$0.9 million from the recently acquired Phasein and Masimo Semiconductor businesses, respectively. Revenue generated through our direct and distribution sales channels increased \$12.6 million, or 15.2%, to \$95.2 million for the three months ended September 29, 2012, compared to \$82.6 million for the three months ended October 1, 2011. During the three months ended September 29, 2012, revenues from our OEM channel increased \$1.9 million, or 12.9%, to \$16.9 million from \$15.0 million for the three months ended October 1, 2011. Included in this increase was \$1.2 million from the recently acquired Phasein business. Our royalty revenue increased \$0.6 million to \$7.0 million in the three months ended September 29, 2012 from \$6.4 million in the three months ended October 1, 2011.

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*Cost of Goods Sold.* Cost of goods sold increased \$5.1 million to \$40.7 million in the three months ended September 29, 2012 from \$35.6 million in the three months ended October 1, 2011. Our total gross margin was 65.8% for both the three months ended September 29, 2012 and the three months ended October 1, 2011. Excluding royalties, product gross margin increased to 63.7% for the three months ended September 29, 2012 from 63.5% for the three months ended October 1, 2011. This increase in product gross margin was primarily due to selected inventory charge-offs related to product redesign and transition activities in 2011 that did not reoccur in 2012, and manufacturing efficiencies. These increases were partially offset by the incremental costs associated with the roll out of a new sensor technology, called X-Cal, and the impact of lower product margins associated with the recently acquired Masimo Semiconductor and Phasein businesses. Excluding Masimo Semiconductor and Phasein, our product gross margin



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would have been 65.1% for the three months ended September 29, 2012. We incurred \$1.3 million in Cercacor royalty expenses for both the three months ended September 29, 2012 and October 1, 2011, which have been eliminated in our condensed consolidated financial results for the periods presented. Had these royalty expenses not been eliminated, our reported product gross profit margin would have been 62.5% and 62.3% for the three months ended September 29, 2012 and October 1, 2011, respectively.

*Selling, General and Administrative.* Selling, general and administrative expenses increased \$8.2 million, or 20.2%, to \$48.3 million for the three months ended September 29, 2012 from \$40.1 million for the three months ended October 1, 2011. Excluding Masimo Semiconductor and Phasein, selling, general and administrative expenses would have increased \$7.1 million, or 17.6%, to \$47.2 million for the three months ended September 29, 2012. This increase was primarily due to a \$2.2 million increase in payroll and related costs associated with increased staffing levels and a \$2.1 million increase in legal fees as a result of additional patent litigation activity. In addition, marketing and related expenses increased \$1.2 million, primarily resulting from additional trade shows attended and increased advertising expenses and professional fees increased by \$0.7 million primarily due to increased consulting project activity. Included in total selling, general and administrative expenses are \$0.7 million and \$0.5 million of direct expenses incurred by Cercacor for the three months ended September 29, 2012 and October 1, 2011, respectively.

*Research and Development.* Research and development expenses increased \$2.7 million, or 29.3%, to \$12.1 million for the three months ended September 29, 2012 from \$9.4 million for the three months ended October 1, 2011. Excluding Masimo Semiconductor and Phasein, research and development expenses would have increased \$2.3 million, or 25.2%, to \$11.7 million for the three months ended September 29, 2012. This increase was primarily due to increased payroll and payroll related costs of \$1.4 million associated with increased research and development staffing levels due to continued investment in research and development efforts. In addition, new project costs and engineering supplies increased \$0.5 million related to new product development projects and activities. Included in total research and development expenses are \$1.0 million and \$0.9 million of engineering expenses incurred by Cercacor for the three months ended September 29, 2012 and October 1, 2011, respectively.

*Non-operating income (expense).* Non-operating income was \$0.9 million for the three months ended September 29, 2012, as compared to non-operating expense of \$0.2 million for the three months ended October 1, 2011. This net change of \$1.1 million was primarily due to the recognition of net realized and unrealized gains on foreign currency denominated transactions during the three months ended September 29, 2012, as compared to the recognition of net realized and unrealized losses on foreign currency denominated transactions during the three months ended October 1, 2011. The net realized and unrealized gains recognized during the three months ended September 29, 2012 resulted primarily from the weakening of the U.S. dollar against the Euro and the Japanese Yen. The net realized and unrealized losses recognized during the three months ended October 1, 2011 resulted primarily from the strengthening of the U.S. dollar against the Euro and Australian dollar, and was partially offset by the weakening of the U.S. dollar against the Japanese Yen.

*Provision for Income Taxes.* Our provision for income taxes was \$5.3 million for the three months ended September 29, 2012, compared to \$3.9 million for the three months ended October 1, 2011. Our effective tax rate increased to 28.1% for the three months ended September 29, 2012, compared to 20.7% for the three months ended October 1, 2011. This increase in the effective tax rate was due primarily to the difference in the mix of income in jurisdictions in which we do business anticipated for the current year as compared to the prior year and the cumulative effect in the three months ended October 1, 2011 of a change in the anticipated annual mix of income in jurisdictions in which we do business. Also contributing to the increase in the effective tax rate was the suspension of the federal research tax credit for 2012, which was partially offset by the derecognition of an uncertain tax position due to the expiration of the statute of limitations. Our future effective income tax rate will depend on various factors, including profits (losses) before taxes, changes to tax law, the recognition and derecognition of tax benefits associated with uncertain tax positions and the geographic composition of pre-tax income.

**Comparison of the Nine Months ended September 29, 2012 to the Nine Months ended October 1, 2011**

*Revenue.* Total revenue increased \$34.5 million, or 10.5%, to \$361.1 million for the nine months ended September 29, 2012 from \$326.6 million for the nine months ended October 1, 2011. Product revenues increased \$37.8 million, or 12.6%, to \$339.6 million in the nine months ended September 29, 2012 from \$301.8 million in the nine months ended October 1, 2011. This increase was primarily due to higher consumable sales resulting from an increase in our installed base of circuit boards and pulse oximeters which we estimate totaled 1,056,000 units at September 29, 2012, up from 950,000 units at October 1, 2011. Contributing to the increase in our product revenue was our rainbow® technology product revenues, which increased \$4.9 million, or 20.1%, to \$29.2 million in the nine months ended September 29, 2012 from \$24.3 million in the nine months ended October 1, 2011. Product revenue of \$339.6 million during the nine months ended September 29, 2012 included \$2.1 million and \$1.5 million from the recently acquired Masimo Semiconductor and Phasein businesses, respectively. Revenue generated through our direct and distribution sales channels increased \$36.7 million, or 14.6%, to \$289.4 million for the nine months ended September 29, 2012, compared to \$252.7 million for the nine months ended October 1, 2011. During the nine months ended September 29, 2012, revenues from our OEM channel increased \$1.1 million, or 2.2%, to \$50.2 million from \$49.1 million in the nine months ended October 1, 2011. Included in this increase was \$1.2 million from the recently acquired Phasein business.



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Our royalty revenue decreased \$3.5 million to \$21.4 million in the nine months ended September 29, 2012 from \$24.9 million in the nine months ended October 1, 2011. This reduction in revenue was primarily due to a reduction in the royalty rate from 13.0% to 7.75% of Covidien's U.S. pulse oximetry sales, which became effective on March 15, 2011. This rate reduction was the result of a second amendment to the original settlement agreement with Covidien, which we entered into on January 28, 2011. For additional discussion of the second amendment, see Note 6 to the condensed consolidated financial statements.

*Cost of Goods Sold.* Cost of goods sold increased \$15.9 million to \$122.0 million in the nine months ended September 29, 2012 from \$106.1 million in the nine months ended October 1, 2011. Our total gross margin decreased to 66.2% for the nine months ended September 29, 2012 from 67.5% for the nine months ended October 1, 2011. Excluding royalties, product gross margin declined to 64.1% for the nine months ended September 29, 2012 from 64.8% for the nine months ended October 1, 2011. This decline in product margin was primarily due to the incremental costs associated with the roll out of a new sensor technology, called X-Cal, and the impact of lower product margins associated with the recently acquired Masimo Semiconductor and Phasein businesses. These declines were partially offset by the selected inventory charge-offs related to product redesign and transition activities in 2011 that did not reoccur in 2012. Excluding Masimo Semiconductor and Phasein, our product gross margin would have been 64.9% for the nine months ended September 29, 2012. We incurred \$3.8 million in Cercacor royalty expenses for both the nine months ended September 29, 2012 and October 1, 2011, which have been eliminated in our condensed consolidated financial results for the periods presented. Had these royalty expenses not been eliminated, our reported product gross profit margin would have been 63.0% and 63.6% for the nine months ended September 29, 2012 and October 1, 2011, respectively.

*Selling, General and Administrative.* Selling, general and administrative expenses increased \$17.1 million, or 13.7%, to \$142.4 million for the nine months ended September 29, 2012 from \$125.3 million for the nine months ended October 1, 2011. Excluding Masimo Semiconductor and Phasein, selling, general and administrative expenses would have increased \$15.6 million, or 12.4%, to \$140.9 million for the nine months ended September 29, 2012. This increase was primarily due to a \$8.8 million increase in payroll and related costs associated with increased staffing levels, and the costs associated with a bi-annual worldwide sales training meeting. In addition, total trade show and advertising expenses increased by \$2.6 million, primarily due to additional trade shows attended, including a worldwide trade show in Q1 2012, which is only held once every four years. Also, professional fees increased by \$1.3 million primarily due to additional consulting projects, legal fees increased \$1.0 million due to increased litigation activity and software licensing expense increased \$0.8 million, primarily due to the addition of sales management software tools. Included in total selling, general and administrative expenses are \$1.8 million and \$1.4 million of direct expenses incurred by Cercacor for the nine months ended September 29, 2012 and October 1, 2011, respectively.

*Research and Development.* Research and development expenses increased \$4.9 million, or 17.2%, to \$33.7 million for the nine months ended September 29, 2012 from \$28.8 million for the nine months ended October 1, 2011. Excluding Masimo Semiconductor and Phasein, research and development expenses would have increased \$4.4 million, or 15.3%, to \$33.2 million for the three months ended September 29, 2012. This increase was primarily due to increased payroll and payroll related costs of \$2.8 million associated with increased research and development staffing levels due to investment in research and development efforts. In addition, new project costs and engineering supplies increased \$1.0 million related to new product development projects and activities. Included in total research and development expenses are \$2.6 million and \$2.5 million of engineering expenses incurred by Cercacor for the nine months ended September 29, 2012 and October 1, 2011, respectively.

*Non-operating income (expense).* Non-operating expense was \$0.1 million for the nine months ended September 29, 2012, as compared to non-operating income of \$0.5 million for the nine months ended October 1, 2011. This net change of \$0.6 million was primarily due to the recognition of net realized and unrealized losses on foreign currency denominated transactions during the nine months ended September 29, 2012, as compared to the recognition of net realized and unrealized gains on foreign currency denominated transactions during the nine months ended October 1, 2011. The net realized and unrealized losses recognized during the nine months ended September 29, 2012 resulted primarily from the strengthening of the U.S. dollar against the Japanese Yen, and was partially offset by the weakening of the U.S. dollar against the British pound. The net realized and unrealized gains recognized during the nine months ended October 1, 2011 resulted primarily from the weakening of the U.S. dollar against the Japanese Yen, and was partially offset by the strengthening of the U.S. dollar against the Australian dollar.

*Provision for Income Taxes.* Our provision for income taxes was \$15.7 million for the nine months ended September 29, 2012 compared to \$17.0 million for the nine months ended October 1, 2011. Our effective tax rate decreased to 25.0% for the nine months ended September 29, 2012, compared to 25.5% for the nine months ended October 1, 2011. This decrease in the effective tax rate was due primarily to the income tax benefit resulting from the conclusion of a prior year tax audit, and the derecognition of an uncertain tax position due to the expiration of the statute of limitations, which was partially offset by a rate increase resulting from the mix of

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income in jurisdictions in which we do business, and the suspension of the federal research tax credit. Our future effective income tax rate will depend on various factors, including profits (losses) before taxes, changes to tax law, the recognition and derecognition of tax benefits associated with uncertain tax positions and the geographic composition of pre-tax income.

***Liquidity and Capital Resources***

As of September 29, 2012, we had cash and cash equivalents of \$113.0 million, of which \$68.0 million was invested in U.S. Treasury bills, \$1.6 million was in money market accounts with major financial institutions and \$43.4 million was in checking accounts and certificates of deposit. We carry cash equivalents at cost which approximates fair value.

As of September 29, 2012, we have cash totaling \$24.4 million held outside of the U.S. A significant portion of this cash held offshore is accessible without a significant tax cost. In managing our day-to-day liquidity and our capital structure, we do not rely on foreign earnings as a source of funds. We currently have sufficient funds for domestic operations and do not anticipate the need to repatriate funds associated with our permanently reinvested foreign earnings. In the event funds that are treated as permanently reinvested are repatriated, we may be required to accrue and pay additional U.S. taxes to repatriate these funds.

During the three months ended September 29, 2012, we received \$7.0 million from Covidien for royalties related to their sales. We expect to continue to receive a royalty based on Covidien's pulse oximetry products sales in the U.S., through the term of the royalty agreement and at least through March 15, 2014. The royalty rate is currently 7.75%.

During the nine months ended September 29, 2012, we used existing cash and cash equivalents to repurchase 1.2 million shares at an average price of \$22.74 per share, totaling \$26.3 million.

*Cash Flows from Operating Activities.* Cash provided by operating activities was \$57.0 million in the nine months ended September 29, 2012. The source of cash consisted primarily of net income including noncontrolling interest of \$47.1 million, and non-cash activity for share-based compensation and depreciation and amortization of \$11.0 million and \$6.5 million, respectively. In addition, deferred revenue increased by \$2.5 million due to the continued growth of our business. These sources of cash were partially offset by an increase in accounts receivable of \$5.0 million due to growth of our business, an increase in prepaid expenses of \$2.9 million due to the prepayment of income taxes and a decrease in accounts payable of \$2.7 million, due to timing of payments.

Cash provided by operating activities was \$54.1 million in the nine months ended October 1, 2011. The source of cash consisted primarily of net income including noncontrolling interests of \$49.9 million and a decrease in royalties receivable of \$5.3 million due to the decline in the royalty rate. Additionally, non-cash activity for share-based compensation and depreciation and amortization were \$10.2 million and \$5.6 million, respectively. These sources of cash were partially offset by an increase in prepaid expenses of \$5.5 million due to the prepayment of income taxes and an increase in deferred cost of goods sold of \$4.3 million due to continued shipments of equipment to customers pursuant to long-term sensor contracts. Additional offsets to the sources of cash were an increase in accounts receivable of \$4.0 million due to both timing of collections and growth of our business, a decrease in accrued compensation of \$2.7 million primarily as a result of 2010 annual bonus payouts in the first quarter of 2011, and an increase in inventory of \$2.4 million to meet the anticipated future demand for our products.

*Cash Flows from Investing Activities.* Cash used in investing activities for the nine months ended September 29, 2012 was \$48.1 million primarily due to a payment of \$37.4 million for the acquisitions of Phasein and the Spire Semiconductor assets, net of cash acquired and excess liabilities assumed. Additionally, \$7.8 million was used for purchases of property and equipment to support our manufacturing operations. Cash used in investing activities for the nine months ended October 1, 2011 was \$5.2 million, consisting of \$3.5 million for purchases of property and equipment to support our manufacturing operations and \$1.7 million for the increase in intangible assets related to capitalized patent costs.

*Cash Flows from Financing Activities.* Cash used in financing activities for the nine months ended September 29, 2012 was \$25.5 million, resulting from \$26.3 million in common stock repurchases. Cash provided by financing activities for the nine months ended October 1, 2011 was \$5.6 million, primarily due to \$5.6 million of proceeds from the issuance of common stock associated with the exercise of stock options.

*Future Liquidity Needs.* In the future, in addition to funding our working capital requirements, we anticipate our primary use of cash to be the equipment that we provide to hospitals under our long-term sensor purchase agreements. We anticipate additional capital purchases related to expanding our worldwide international operations including manufacturing, sales, marketing and other areas of necessary infrastructure growth. Our focus on international expansion will also require both continuing and incremental investments in facilities and infrastructure in the Americas, Europe and Asia. We also anticipate possible uses of cash for the acquisition of



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technologies or the acquisition of technology companies. The amount and timing of our actual investing activities will vary significantly depending on numerous factors, such as the progress of our product development efforts, our timetable for international sales operations and manufacturing expansion and both domestic and international regulatory requirements. Despite these capital investment requirements, we anticipate that our existing cash and cash equivalents will be sufficient to meet our working capital requirements, capital expenditures and operations for at least the next 12 months.

*Current Financing Arrangements.* As of September 29, 2012, we had capital leases related to office equipment with an outstanding balance of \$0.1 million. We had no other debt obligations.

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

We do not currently have, nor have we ever had, any relationships with unconsolidated entities or financial partnerships, such as entities referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts. As a result, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we engaged in these relationships.

### ***Critical Accounting Policies and Estimates***

The discussion and analysis of our financial condition and results of operations is based on our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these condensed consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements, as well as revenue and expenses during the reporting periods. Significant estimates include: determination of accounts receivable allowances, inventory reserves, warranty reserves, rebate reserves, valuation of our stock options, distributor channel inventory, royalty revenues, deferred revenue and uncertain income tax positions. We evaluate our estimates and judgments on an ongoing basis. We base our estimates on historical experience and on various other factors we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results therefore could differ materially from those estimates under different assumptions or conditions. For a description of our critical accounting policies and estimates, please refer to the

Critical Accounting Estimates section of the Management's Discussion and Analysis of Financial Condition and Results of Operations section contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 filed with the SEC on February 17, 2012. There have been no material changes in our critical accounting policies since December 31, 2011.

### ***Inventory/Reserves for Excess or Obsolete Inventory***

Inventories are stated at the lower of cost or market. Cost is determined using a standard cost method, which approximates FIFO (first-in, first-out). Inventory valuation reserves are recorded for materials that have become obsolete or are no longer used in current production and for inventory that has a market value less than the carrying value in inventory. We generally purchase raw materials in quantities that we anticipate will be fully used within one year. However, changes in operating strategy and customer demand, and frequent unpredictable fluctuations in market values for such materials can limit our ability to effectively utilize all of the raw materials purchased and sold through resulting finished goods to customers for a profit. We regularly monitor potential inventory excess, obsolescence and lower market values compared to standard costs and, when necessary, reduce the carrying amount of our inventory to its market value.

We develop our inventory reserve based on an evaluation of the expected future use of our inventory on an item by item basis. We apply historical obsolescence rates to estimate the loss on inventory expected to have a recovery value below cost. Our historical obsolescence rates are developed from our company specific experience for major categories of inventory, which are then applied to excess inventory on an item by item basis. We also develop other specific inventory reserves when we become aware of other unique events that result in a known recovery value below cost. For inventory items that have been written down, either due to the inventory reserve analysis or due to a specific event, the reduced value becomes the new cost basis. The new cost basis of an inventory item is not marked up in subsequent periods. Our inventory reserve was \$5.2 million and \$5.4 million as of September 29, 2012 and December 31, 2011, respectively. If our estimates for potential inventory losses prove to be too low, then our future earnings will be affected when the related additional inventory losses are recorded.

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***Revenue Recognition***

We follow the current authoritative guidance for software revenue recognition. Based on these requirements, we recognize revenue when: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the price is fixed or determinable, and (iv) collectability is reasonably assured. We enter into agreements to sell pulse oximetry and related products and services as well as multiple deliverable arrangements that include various combinations of products and services. While the majority of our sales transactions contain standard business terms and conditions, there are some transactions that contain non-standard business terms and conditions. As a result, contract interpretation is sometimes required to determine the appropriate accounting including: (a) whether an arrangement exists, (b) how the arrangement consideration should be allocated among the deliverables if there are multiple deliverables, (c) when to recognize revenue on the deliverables, and (d) whether undelivered elements are essential to the functionality of the delivered elements. Changes in judgments on these assumptions and estimates could materially impact the timing of revenue recognition.

In September 2009, the Financial Accounting Standards Board, or FASB, amended the accounting standards related to revenue recognition for arrangements with multiple deliverables. The new standard changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable to be based on the relative selling price. The FASB also amended the accounting standards for revenue recognition to exclude software that is contained in a tangible product from the scope of software revenue guidance if the software is essential to the tangible product's functionality. We adopted these new standards on a prospective basis. Therefore, the new standards apply only to revenue arrangements entered into or materially modified beginning January 2, 2011. Revenue arrangements entered into or materially modified prior to January 2, 2011 continue to be accounted for under the prior authoritative guidance. For revenue arrangements that were entered into or materially modified after the adoption of these standards, implementation of this new authoritative guidance had no significant impact on our reported revenue in fiscal 2011 as compared to revenue if the related arrangements entered into or materially modified after the effective date were subject to the accounting requirements in effect in the prior year.

The new standards establish a hierarchy to determine the selling price to be used for allocating revenue to deliverables as follows:

(i) vendor-specific objective evidence of fair value, or VSOE, (ii) third-party evidence of selling price, or TPE, and (iii) best estimate of the selling price, or ESP. VSOE of fair value is defined as the price charged when the same element is sold separately. VSOE generally exists only when the deliverable is sold separately and is the price actually charged for that deliverable. TPE generally does not exist for the majority of our products because of their uniqueness. The objective of ESP is to determine the price at which we would transact a sale if the product was sold on a stand-alone basis. In the absence of VSOE and TPE, we determine ESP for our products by considering multiple factors including, but not limited to, features and functionality of the product, geographies, type of customer, contractual prices pursuant to Group Purchasing Organization, or GPO, contracts, our pricing and discount practices, and market conditions.

A deliverable in an arrangement qualifies as a separate unit of accounting if the delivered item has value to the customer on a stand-alone basis. Most of our products in a multiple deliverable arrangement qualify as separate units of accounting. In the case of our monitoring equipment products containing embedded Masimo SET software, we have determined that the hardware and software components function together to deliver the products' essential functionality, and therefore, represent a single deliverable. In accordance with the new guidance, the revenue from the sale of these products no longer falls within the scope of the software revenue recognition guidance. Software deliverables, such as rainbow parameter software, which do not function together with hardware components to provide the products' essential functionality, continue to be accounted for under software revenue recognition guidance. Our multiple deliverable arrangements may therefore have software deliverables that are subject to the existing software revenue recognition guidance. The revenue for these multiple-element arrangements is allocated to the software deliverables and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy in the new revenue recognition accounting guidance for arrangements with multiple deliverables.

Our sales under long-term sensor purchase contracts are generally structured such that we agree to provide up-front and at no charge certain monitoring equipment, software, installation, training and ongoing warranty support in exchange for the hospital's agreement to purchase sensors over the term of the agreement, which ranges from three to six years. The sensors are essential to the functionality of the monitoring equipment and, therefore, represent a substantive performance obligation. We do not recognize any revenue when the monitoring and related equipment and software is delivered to the hospitals and installation and training is complete. We recognize revenue for these delivered elements, on a pro-rata basis, as the sensors are delivered under the long-term purchase commitment. The adoption of the new guidance for revenue recognition did not change this pattern of revenue recognition for long-term sensor purchase contracts. The cost of the monitoring equipment initially placed at the hospitals is deferred and amortized to cost of goods sold over the life of the underlying long-term sensor purchase contract.

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To the extent that the allocation of revenue to multiple deliverables under long-term sensor agreements depends on our estimated selling prices, there is uncertainty over the percentage allocation to equipment, sensors and software. A change in the factors we use to estimate selling price, the weighting we assign to different factors, or a change in our pricing and discounting strategy could result in a different allocation to the deliverables in an arrangement. However, because we recognize revenue as sensors are delivered over the term of the agreement, the total revenue recognized under long-term sensor agreements in any period is not dependent on the allocation to the deliverables. The total amount of revenue recognized under long-term sensor agreements in a period is dependent on the amount of sensors shipped in the period. Our long-term sensor agreements provide for a minimum annual purchase commitment by our customers, but the timing and amount of customer purchases may vary from period to period.

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

Market risk represents the risk of changes in the value of market risk sensitive instruments caused by fluctuations in interest rates, foreign exchange rates and commodity prices. We are exposed to various market risks that may arise from adverse changes in market rates and prices, such as interest rates, foreign exchange fluctuations and inflation. We do not enter into derivatives, including forward contracts, or other financial instruments for trading or speculative purposes.

***Interest Rate Risk***

Our exposure to market risk for changes in interest rates relates to the increase or decrease in the amount of interest income we can earn on our investment portfolio and on the increase or decrease in the amount of interest expense we must pay with respect to our various outstanding debt instruments. Our risk associated with fluctuation in interest expense is limited to our outstanding capital lease arrangements, which have fixed interest rates. Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes. We ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We reduce default risk by investing in investment grade securities. A hypothetical 100 basis point change in interest rates along the entire interest rate yield curve would not significantly affect the fair value of our interest-sensitive financial instruments at September 29, 2012. Declines in interest rates over time will, however, reduce our interest income and expense while increases in interest rates will increase our interest income and expense.

***Foreign Currency Exchange Rate Risk***

Our primary foreign currency exchange rate exposures are with the Euro, the yen, the Canadian dollar, the British pound and the Australian dollar against the U.S. dollar. A majority of our assets and liabilities are maintained in the United States in U.S. dollars and a majority of our sales and expenditures are transacted in U.S. dollars. We transact with foreign customers in currencies other than the U.S. dollar. These foreign currency revenues, when converted into U.S. dollars, can vary depending on average exchange rates during a respective period. In addition, we are exposed to foreign currency gains or losses on outstanding foreign currency denominated receivables. Realized and unrealized foreign currency gains or losses on these transactions are included in our statements of comprehensive income as incurred. Certain of our foreign sales support subsidiaries transact in their respective country's local currency, which is also their functional currency. As a result, expenses of these foreign subsidiaries when converted into U.S. dollars can vary depending on average monthly exchange rates during a respective period. Certain intercompany transactions may give rise to realized and unrealized foreign currency gains or losses. These foreign currency gains or losses are included in our statements of comprehensive income as incurred. In addition, any other transactions between us or our subsidiaries and a third party, denominated in a currency different from the functional currency, are a foreign currency transaction. Realized and unrealized foreign currency gains or losses on these transactions are included in our statements of comprehensive income as incurred and are converted to U.S. dollars at average exchange rates for a respective period.

The balance sheets of our foreign subsidiaries whose functional currency is not the U.S. dollar are translated into U.S. dollars at the rate of exchange at the balance sheet date and the statements of comprehensive income and cash flows are translated into U.S. dollars using the average monthly exchange rate during the period. Any foreign exchange gain or loss as a result of translating the balance sheets of our foreign subsidiaries whose functional currency is not the U.S. dollar is included in equity as a component of accumulated other comprehensive income.

Foreign currency exchange rates have experienced significant movements recently and may continue to do so in the future. The effect of a 10% change in foreign currency exchange rates could have a material effect on our future operating results or cash flows, depending on which foreign currency exchange rates change and depending on the directional change (either a strengthening or weakening against the U.S. dollar). As our foreign operations continue to grow, our exposure to foreign currency exchange rate risk may become more significant.



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***Inflation Risk***

We do not believe that inflation has had a material effect on our business, financial condition or results of operations during the periods presented. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could have a material adverse effect on our business, financial condition and results of operations.

**Item 4. Controls and Procedures**

***Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures***

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended, or the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's regulations, rules and forms and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure.

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. As required by Rule 13a-15(b) promulgated by the SEC under the Exchange Act, we carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

***Changes in Internal Control Over Financial Reporting***

There has been no change in our internal control over financial reporting during the quarter ended September 29, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

On February 3, 2009, we filed a patent infringement suit against Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH related to Philips FAST pulse oximetry technology and certain of Philips patient monitors. The suit was brought in the U.S. District Court for the District of Delaware. Two patents originally asserted in this suit, related to our measure-through motion technology, were successfully enforced in our previous suit against Nellcor. On June 15, 2009, Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH answered our complaint and Philips Electronics North America Corporation filed antitrust and patent infringement counterclaims against us as well as counterclaims seeking declaratory judgments of invalidity on the patents asserted by us against Philips. On July 9, 2009, we filed our answer denying Philips counterclaims and asserting various defenses. We also asserted counterclaims against Philips for fraud, intentional interference with prospective economic advantage and for declaratory judgments of noninfringement and invalidity with respect to the patents asserted by Philips against us. Philips later added a claim for infringement of one additional patent. Subsequently, the Court bifurcated Philips antitrust claims and its patent misuse defense, as well as stayed the discovery phase on those claims pending trial in the patent case. On October 4, 2010, the Court limited the number of patents to be construed to four for us and three for Philips. In addition, on October 6, 2010, the Court denied Philips motion to bifurcate and stay damages in the patent case. In December 2010, the Court held a hearing regarding the construction of the patent claims and the Magistrate Judge issued a Report and Recommendation on claim construction on February 18, 2011. On January 17, 2012, the District Court Judge issued a claim construction order, adopting the Report and Recommendation of the Magistrate Judge, except with respect to one construction on one of our patents to which we had objected. With respect to this one claim construction, the District Court Judge did not adopt the recommendation from the Magistrate Judge and adopted the construction proposed by us. We believe that we have good and substantial defenses to the antitrust and patent infringement claims asserted by Philips. There is no guarantee that we will prevail in this suit or receive any damages or other relief if we do prevail.

From time to time, we are involved in legal proceedings in the ordinary course of business. Other than the proceedings described above and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 filed with the SEC on February 17, 2012, we are not currently involved in any material legal proceedings.

**Item 1A. Risk Factors**

*Before you decide to invest or maintain an interest in our common stock, you should consider carefully the risks described below, which have been updated since the filing of our Annual Report on Form 10-K with the SEC on February 17, 2012, together with the other information contained in this Quarterly Report on Form 10-Q. We believe the risks described below are the risks that are material to us as of the date this Quarterly Report on Form 10-Q is initially filed with the SEC. If any of the following risks comes to fruition, our business, financial condition, results of operations and growth prospects would likely be materially and adversely affected. In these circumstances, the market price of our common stock could decline, and you could lose all or part of your investment or interest.*

*We have marked with an asterisk (\*) those risk factors below that include a substantive change from or update to the risk factors included in our Annual Report on Form 10-K filed with the SEC on February 17, 2012.*

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**Risks Related to Our Revenues**

**We currently derive substantially all of our revenue from our Masimo SET<sup>®</sup> platform, Masimo rainbow<sup>®</sup> SET platform and related products. If this technology and the related products do not continue to achieve market acceptance, our business, financial condition and results of operations would be adversely affected.**

We are dependent upon the success and market acceptance of our proprietary Masimo SET<sup>®</sup>. Currently, our primary product offerings are based on the Masimo SET<sup>®</sup> platform. Continued market acceptance of products incorporating Masimo SET<sup>®</sup> will depend upon our ability to continue to provide evidence to the medical community that our products are cost-effective and offer significantly improved performance compared to conventional pulse oximeters. Health care providers that currently have significant investments in competitive pulse oximetry products may be reluctant to purchase our products. If hospitals and other health care providers do not believe our Masimo SET<sup>®</sup> platform is cost-effective, safe or more accurate or reliable than competitive pulse oximetry products, they may not buy our products in sufficient quantities to enable us to be profitable. In addition, allegations regarding the safety and effectiveness of our products, whether or not substantiated, may impair or impede the acceptance of our products. If we are unable to achieve additional market acceptance of our core technology or products incorporating Masimo SET<sup>®</sup>, we will not generate significant revenue growth from the sale of our products.

**Some of our products, including those based on licensed rainbow<sup>®</sup> technology, are in development or have been recently introduced into the market and may not achieve market acceptance, which could limit our growth and adversely affect our business, financial condition and results of operations.**

Our products that have been recently introduced into the market, including, but not limited to, those based on rainbow<sup>®</sup> technology, a technology that we license, may not be accepted in the market. In September 2008, we began our limited market release of hemoglobin, and focused on obtaining data and clinical feedback on the performance of the product in the hospital. In October 2008, we received FDA clearance for Pronto<sup>®</sup>, a handheld noninvasive multi-parameter testing device that uses our rainbow<sup>®</sup> SET technology, to provide oxygen saturation, pulse rate, perfusion index and spot-checking of hemoglobin levels. In the first quarter of 2009, we fully launched our hemoglobin product for continuous and noninvasive monitoring in the hospital. In January 2012, we received FDA clearance for Pronto-7<sup>®</sup> and began full market release. In June 2010, we initiated a full commercial release of rainbow Acoustic Monitoring<sup>™</sup> after a limited market release that allowed us to evaluate the product's performance in the field.

Given that certain rainbow<sup>®</sup> technology products are new to the marketplace, we do not know to what degree the market will accept these products, if at all. Even if our customers recognize the benefits of our products, we cannot assure you that our customers will purchase them in quantities sufficient for us to be profitable or successful. We will need to invest in significant sales and marketing resources to achieve market acceptance of these products with no assurance of success. The degree of market acceptance of these products will depend on a number of factors, including:

perceived advantages of our products and their sales prices;

perceived safety and effectiveness of our products;

reimbursement available through Centers for Medicare and Medicaid Services, or CMS, programs for using our products; and

introduction and acceptance of competing products or technologies.

In general, our recent noninvasive measurement technologies are novel products that may be considered disruptive. These recent technologies have performance levels that we believe are acceptable for many clinical environments but may be insufficient in others. In addition, these technologies may perform better in some patients and settings than others. The performance of these technologies shows variability across a population that follows a standard gaussian distribution described in the accuracy specifications. Over time, we hope to reduce this variability and, if we do, we expect these recent technologies to become more useful in additional environments and to become more widely adopted. This is the adoption pattern we have experienced historically with our previously released measurements, such as oxygen saturation, and what we expect to experience in the future with our current and future technologies. Although we will seek to reduce this variability over time, we may not be successful. If our products do not gain market acceptance or if our customers prefer our competitors' products, our potential growth would

be limited, which would adversely affect our business, financial condition and results of operations.

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**Our ability to commercialize new products, new or improved technologies and additional applications for Masimo SET<sup>®</sup> and our right to use rainbow<sup>®</sup> technology are each limited to certain markets by our Cross-Licensing Agreement with Cercacor, which may impair our growth and adversely affect our financial condition and results of operations.**

In May 1998, we spun off a newly-formed entity, Cercacor, and provided it rights to use Masimo SET<sup>®</sup> to commercialize non-vital signs monitoring applications while we retained the rights to Masimo SET<sup>®</sup> to commercialize vital signs monitoring applications. On May 2, 1998, we entered into a cross-licensing agreement with Cercacor, which has been amended several times, most recently in an Amended and Restated Cross-Licensing Agreement, effective January 1, 2007, or the Cross-Licensing Agreement. Under the Cross-Licensing Agreement, we granted Cercacor:

an exclusive, perpetual and worldwide license, with sublicense rights, to use all Masimo SET<sup>®</sup> owned by us, including all improvements on this technology, for the monitoring of non-vital signs parameters and to develop and sell devices incorporating Masimo SET<sup>®</sup> for monitoring non-vital signs parameters in any product market in which a product is intended to be used by a patient or pharmacist rather than by a professional medical caregiver, which we refer to as the Cercacor Market, and

a non-exclusive, perpetual and worldwide license, with sublicense rights, to use all Masimo SET<sup>®</sup> for measurement of vital signs in the Cercacor Market.

Non-vital sign measurements consist of body fluid constituents other than vital sign measurements, including, but not limited to, carbon monoxide, methemoglobin, blood glucose, hemoglobin and bilirubin. Under the Cross-Licensing Agreement, we are only permitted to sell devices utilizing Masimo SET<sup>®</sup> for the monitoring of non-vital signs parameters in markets where the product is intended to be used by a professional medical caregiver, including, but not limited to, hospital caregivers and alternate care market facility caregivers, rather than by a patient or pharmacist, which we refer to as the Masimo Market. Accordingly, our ability to commercialize new products, new or improved technologies and additional applications for Masimo SET<sup>®</sup> is limited. In particular, our inability to expand beyond the Masimo Market may impair our growth and adversely affect our financial condition and results of operations.

Pursuant to the Cross-Licensing Agreement, we have licensed from Cercacor the right to make and distribute products in the Masimo Market that utilize rainbow<sup>®</sup> technology for the measurement of only carbon monoxide, methemoglobin, fractional arterial oxygen saturation and hemoglobin, which includes hematocrit. As a result, the opportunity to expand the market for our products incorporating rainbow<sup>®</sup> technology is limited, which could limit our ability to maintain or increase our revenue and impair our growth.

**We face competition from other companies, many of which have substantially greater resources than we do. If we do not successfully develop and commercialize enhanced or new products that remain competitive with new products or alternative technologies developed by others, we could lose revenue opportunities and customers, and our ability to grow our business would be impaired.**

A number of our competitors have substantially greater capital resources, larger customer bases, larger sales forces than ours, and have established stronger reputations with target customers and built relationships with GPOs that are more effective than ours. We face substantial competition from companies developing products that compete with our Masimo SET<sup>®</sup> platform for use with third-party monitoring systems. We also face competition from companies currently marketing pulse oximetry monitors.

The medical device industry is characterized by rapid product development and technological advances, which places our products at risk of obsolescence. Our long-term success depends upon the development and successful commercialization of new products, new or improved technologies and additional applications for Masimo SET<sup>®</sup> and licensed rainbow<sup>®</sup> technology. The research and development process is time-consuming and costly and may not result in products or applications that we can successfully commercialize. In particular, we may not be able to successfully commercialize our products for applications other than arterial blood oxygen saturation and pulse rate monitoring, including respiration rate, hemoglobin, carboxyhemoglobin and methemoglobin monitoring. If we do not successfully adapt our products and applications both within and outside these measurements, we could lose revenue opportunities and customers. Furthermore, one or more of our competitors may develop products that are substantially equivalent to our FDA-cleared products, or those of our original equipment manufacturer, or OEM, partners, whereby they may be able to use our products or those of our OEM partners, as predicate devices to more quickly obtain FDA clearance of their competing products. Competition could result in reductions in the price of our products, fewer orders for our products, a reduction of our gross margins and a loss of our market share.



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**We depend on our domestic and international OEM partners for a portion of our revenue. If they do not devote sufficient resources to the promotion of products that use Masimo SET® and licensed rainbow® technology, our business would be harmed.**

We are, and will continue to be, dependent upon our domestic and international OEM partners for a portion of our revenue through their marketing, selling and distribution of certain of their products that incorporate Masimo SET® and licensed rainbow® technology. Although we expect that our OEM partners will accept and actively market, sell and distribute products that incorporate licensed rainbow® technology, they may not elect, and they have no contractual obligation, to do so. Because products that incorporate our technologies may represent a relatively small percentage of business for some of our OEM partners, they may have less incentive to promote these products rather than other products that do not incorporate these technologies. In addition, some of our OEM partners offer products that compete with ours. Therefore, we cannot guarantee that our OEM partners, or any company that might acquire any of our OEM partners, will vigorously promote products incorporating Masimo SET® and licensed rainbow® technology, or at all. The failure of our OEM partners to successfully market, sell or distribute products incorporating these technologies, the termination of OEM agreements, the loss of OEM partners or the inability to enter into future OEM partnership agreements would have a material adverse effect on our business, financial condition and results of operations.

**\* If we fail to maintain or develop relationships with GPOs, sales of our products would decline.**

Our ability to sell our products to U.S. hospitals depends, in part, on our relationships with GPOs. Many existing and potential customers for our products become members of GPOs. GPOs negotiate beneficial pricing arrangements and contracts, which are sometimes exclusive, with medical supply manufacturers and distributors.

These negotiated prices are made available to a GPO's affiliated hospitals and other members. If we are not one of the providers selected by a GPO, the GPO's affiliated hospitals and other members may be less likely or unlikely to purchase our products. If a GPO has negotiated a strict sole source, market share compliance or bundling contract for another manufacturer's products, we may be prohibited from making sales to members of the GPO for the duration of the contractual arrangement. For the three and nine months ended September 29, 2012, shipments of our pulse oximetry products to customers that are members of GPOs represented \$62.3 million and \$188.0 million, respectively, of our revenue from sales to U.S. hospitals. Our failure to renew our contracts with GPOs may cause us to lose market share and could have a material adverse effect on our sales, financial condition and results of operations. In addition, if we are unable to develop new relationships with GPOs, our competitive position would likely suffer and our business would be harmed.

**Inadequate levels of coverage or reimbursement from governmental or other third-party payers for our products, or for procedures using our products, may cause our revenue to decline.**

Sales of our products depend in part on the reimbursement and coverage policies of governmental and private health care payers. The ability of our health care provider customers, including hospitals, to obtain adequate coverage and reimbursement for our products, or for the procedures in which our products are used, may impact our customers' purchasing decisions. Therefore, our customers' inability to obtain adequate coverage and reimbursement for our products would have a material adverse effect on our business.

Third-party payers have adopted, and are continuing to adopt, health care policies intended to curb rising health care costs. These policies include, among others:

controls on reimbursement for health care services and price controls on medical products and services;

limitations on coverage and reimbursement for new medical technologies and procedures; and

the introduction of managed care and prospective payment systems in which health care providers contract to provide comprehensive health care for a fixed reimbursement amount per person or per procedure.

We cannot guarantee a governmental or third-party payer will reimburse, or continue to reimburse, a customer for the cost of our products. Some payers have indicated that they are not willing to reimburse for certain of our products or for the procedures in which our products are used. For example, some insurance carriers have issued policies denying coverage for transcutaneous hemoglobin measurement on the grounds that the technology is investigational in the outpatient setting. Other payers are continuing to investigate our products to determine if they will provide reimbursement to our customers. We are working with these payers to obtain reimbursement, but may not be successful. These trends could lead

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to pressure to reduce prices for our current products and product candidates and could cause a decrease in the size of the market or a potential increase in competition that could adversely affect our business, financial condition and results of operations.

**Our customers may reduce, delay or cancel purchases due to a variety of factors, such as lower hospital census levels or third-party guidelines, which could adversely affect our business, financial condition and results of operations.**

Our customers are facing a growing level of uncertainties, such as lower overall hospital census for paying patients and the impact of that lower census on hospital budgets.



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In addition, there are specific portions of our business, such as our OEM customers, that, due to their capital equipment sales model, could be impacted by the ongoing economic uncertainties and the resulting constraints on hospital budgets. These hospital budget constraints could cause our OEMs more difficulty in selling their large, relatively high priced multi-parameter devices which, in turn, could reduce our board sales to our OEM customers. In addition, certain of our products, including our rainbow<sup>®</sup> measurements such as carbon monoxide, methemoglobin and hemoglobin, are sold with upfront license fees and more complex, and therefore, more expensive sensors could be impacted by hospital budget reductions.

In addition, states and other local regulatory authorities may issue guidelines regarding the appropriate scope and use of our products from time to time. For example, our SpCO<sup>®</sup> monitoring devices may be subject to authorization by individual states as part of Emergency Medical Services, or EMS, scope of practice procedures. The State of California recently categorized SpCO<sup>®</sup> as a laboratory test and therefore outside the scope of practice for EMS providers. Although a lack of inclusion into scope of practice procedures does not prohibit usage, it may limit adoption.

**\* The loss of any large customer, or distributor, or any cancellation or delay of a significant purchase by a large customer could reduce our net sales and harm our operating results.**

We also have a concentration of OEM, distribution and direct customers. If for any reason we were to lose our ability to sell to a specific group or class of customers, or through a distributor, we could experience a significant reduction in revenue, which would adversely impact our operating results. Also, we cannot provide any assurance that we will retain our current customers or groups of customers, or distributors, or that we will be able to attract and retain additional customers in the future. For the three months ended September 29, 2012, we had sales through two just-in-time distributors, which each represented 15% and 11% of our total revenue, respectively. The loss of any large customer or distributor, could have a material adverse effect on our financial condition and results of operations.

**\* Organizations that manufacture imitation Masimo sensors and third party medical device reprocessors that reprocess our single-patient-use sensors and then resell them to hospitals at a cost lower than our new sensors may harm our reputation and cause our revenue to decline. Our development of a new technology designed to provide hospitals, clinicians and their patients with sensors that reflect true Masimo quality and performance may not be accepted by all of our customers, which may adversely affect our business, financial condition and results of operations.**

We are aware that other organizations are manufacturing imitation Masimo sensors. In addition, we are aware that certain medical device reprocessors have been collecting our used *single-patient-use* sensors from hospitals and then reprocessing, repackaging and reselling those sensors to hospitals for other patients. Our experience with both these imitation sensors and reprocessed sensors is that they provide inferior performance, increased sensor utilization, reduced comfort and a number of monitoring problems. Notwithstanding these limitations and despite our customers' acknowledged preference for genuine Masimo single-patient-use adhesive sensors due to performance and risk of contamination, over the past two years there has been an increase in our customers' awareness of these imitation sensors and reprocessing programs and some customers have indicated a willingness to consider purchasing some of their sensor requirements from these imitation manufacturers and third party reprocessors in an effort to reduce their overall operating costs. These imitation and reprocessed sensors have led to and may continue to lead to confusion with our genuine Masimo products, have reduced and may continue to reduce our revenue, and in some cases have harmed and may continue to harm our reputation, if customers conclude incorrectly that these imitation or reprocessed sensors are original Masimo sensors. In addition, we have expended a significant amount of time and expense investigating issues caused by imitation and reprocessed sensors, troubleshooting problems stemming from such sensors, educating customers about why imitation and reprocessed sensors do not perform up to our performance level and to their expectations, and enforcing our proprietary rights against the imitation manufacturers and reprocessors and under our customer contracts.

We have developed a new technology that is designed to ensure our customers get the performance they expect by using genuine Masimo sensors. This new technology has been included in sensors shipped since Q4 2011 and we expect that nearly all of our distribution channels throughout the world will be carrying these new sensors by the end of 2012. While most customers will not observe any difference when compared to our prior sensors, we believe this technology will help ensure that hospitals, clinicians and, ultimately, their patients, receive true Masimo sensor measurement quality and performance, and will curtail some of the harm to us that results when customers experience performance and other problems with imitation and reprocessed sensors. As a result, although we believe that this technology will be viewed favorably by the overwhelming majority of hospitals and clinicians, there are no assurances that all of our customers will view it positively, which may reduce certain customer demand for our new sensors and, as a result, have a material adverse effect on our business, financial condition and results of operations.

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**From time to time we may carry out strategic initiatives that are not viewed favorably by our customers, which may reduce demand for our products.**

We expect to continue to implement new technologies and take action to protect and enforce our contractual, intellectual property and other rights. Although we believe implementing new technologies and taking these actions are, and will continue to be, in the best interest of patient care, the company and our stockholders, there are no assurances that the market will perceive their benefits, which may result in reduced customer demand for our products and cause our revenue to decline.

**\* Covidien may seek to avoid paying any royalties to us after March 15, 2014, which would significantly reduce our royalty revenue, total revenues and adversely affect our business, financial condition and results of operations.**

We are party to a settlement agreement with Covidien. Under the current settlement agreement, we earn royalties on Covidien's total U.S. based pulse oximetry sales. For the three months ended September 29, 2012, our royalties from the Covidien settlement agreement totaled \$7.0 million. Because these royalty payments do not carry any significant cost, they result in significant improvements to our reported gross profit, operating income levels and earnings per share. As a result, an elimination of royalties that we earn under the settlement agreement in the future will have a significant impact on our revenue, gross margins, operating income and earnings per share.

On January 28, 2011, we entered into a second amendment to this settlement agreement with Covidien. As part of this amendment, which became effective on March 15, 2011, Covidien agreed to pay us a royalty at a rate of 7.75% of its U.S. pulse oximetry revenue, as that term is defined in the January 28, 2011 second amendment, from March 15, 2011 through at least March 15, 2014. In exchange for this royalty payment, we have provided Covidien with a covenant not to sue for its current pulse oximetry products, but not for any other technologies that Covidien may add, pursuant to the second amendment. After March 15, 2014, Covidien may stop paying us any royalties, which would have a material adverse impact on our total revenue, gross margins, operating income and earnings per share.

### **Risks Related to Our Intellectual Property**

**If the patents we own or license, or our other intellectual property rights, do not adequately protect our technologies, we may lose market share to our competitors and be unable to operate our business profitably.**

Our success depends significantly on our ability to protect our rights to the technologies used in our products, including Masimo SET<sup>®</sup> and licensed rainbow<sup>®</sup> technology. We rely on patent protection, trade secrets, as well as a combination of copyright and trademark laws and nondisclosure, confidentiality and other contractual arrangements to protect our technology and rights. However, these legal means afford only limited protection and may not adequately protect our rights or permit us to gain or maintain any competitive advantage. In addition, we cannot be assured that any of our pending patent applications will result in the issuance of a patent to us. The U.S. Patent and Trademark Office, or PTO, may deny or require significant narrowing of claims in our pending patent applications, and patents issued as a result of the pending patent applications, if any, may not provide us with significant commercial protection or be issued in a form that is advantageous to us. We could also incur substantial costs in proceedings before the PTO. Our issued and licensed patents and those that may be issued or licensed in the future, may expire or may be challenged, invalidated or circumvented, which could limit our ability to stop competitors from marketing related technologies. Some of our patents related to our Masimo SET<sup>®</sup> algorithm technology began to expire in March 2011. Additionally, upon expiration of other issued or licensed patents, we may lose some of our rights to exclude competitors from making, using, selling or importing products using the technology based on the expired patents. While we seek to offset potential losses relating to important expiring patents by securing additional patents on commercially desirable improvements, there can be no assurance that we will be successful in securing such additional patents, or that such additional patents will adequately offset the effect of expiring patents. We also must rely on contractual rights with the third parties that license technology to us to protect our rights in the technology licensed to us. There is no assurance that competitors will not be able to design around our patents. We also rely on unpatented proprietary technology. We cannot assure you that we can meaningfully protect all our rights in our unpatented proprietary technology or that others will not independently develop substantially equivalent proprietary products or processes or otherwise gain access to our unpatented proprietary technology.

We seek to protect our know-how and other unpatented proprietary technology with confidentiality agreements and intellectual property assignment agreements with our employees, our OEM partners, independent distributors and consultants. However, such agreements may not be enforceable or may not provide meaningful protection for our proprietary information in the event of unauthorized use or disclosure or other breaches of the agreements or in the event that our competitors discover or independently develop similar or identical designs or other proprietary information. In addition, we rely on the use of registered and common law trademarks with respect to the brand names of some of our products. Common law trademarks provide less protection than registered trademarks. Loss of rights in our trademarks could adversely affect our business, financial condition and results of operations.



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Furthermore, the laws of foreign countries may not protect our intellectual property rights to the same extent as the laws of the U.S. If we fail to apply for intellectual property protection or if we cannot adequately protect our intellectual property rights in these foreign countries, our competitors may be able to compete more effectively against us, which could adversely affect our competitive position, as well as our business, financial condition and results of operations.

**If third parties claim that we infringe their intellectual property rights, we may incur liabilities and costs and may have to redesign or discontinue selling certain products.**

Companies in the medical device industry have used intellectual property litigation to gain a competitive advantage in the marketplace. We face the risk of claims that we have infringed on third parties' intellectual property rights. Searching for existing intellectual property rights may not reveal important intellectual property and our competitors may also have filed for patent protection, which is not publicly-available information, or claimed trademark rights that have not been revealed through our availability searches. In addition, many of our employees were previously employed at other medical device companies. We may be subject to claims that our employees have disclosed, or that we have used, trade secrets or other proprietary information of our employees' former employers. Our efforts to identify and avoid infringing on third parties' intellectual property rights may not always be successful. Any claims of patent or other intellectual property infringement against us, even those without merit, could:

increase the cost of our products;

be expensive and time consuming to defend;

result in us being required to pay significant damages to third parties;

force us to cease making or selling products that incorporate the challenged intellectual property;

require us to redesign, reengineer or rebrand our products, product candidates and technologies;

require us to enter into royalty or licensing agreements in order to obtain the right to use a third party's intellectual property on terms that may not be favorable or acceptable to us;

require us to indemnify third parties pursuant to contracts in which we have agreed to provide indemnification for intellectual property infringement claims;

divert the attention of our management and other key employees;

result in our customers or potential customers deferring or limiting their purchase or use of the affected products impacted by the claims until the claims are resolved; and

otherwise have a material adverse effect on our business, financial condition and results of operations.

In addition, new patents obtained by our competitors could threaten the continued commercialization of our products in the market even after they have already been introduced. In 2009, Philips Electronics North America Corporation filed antitrust and patent infringement counterclaims against us, as further explained in Part I, Item 3 of our Annual Report on Form 10-K filed with the SEC on February 17, 2012 and Part II, Item 1

of this Quarterly Report on Form 10-Q.

**We believe competitors may currently be violating and may in the future violate our intellectual property rights, and we may bring additional litigation to protect and enforce our intellectual property rights, which may result in substantial expense and may divert our attention from implementing our business strategy.**

We believe that the success of our business depends, in significant part, on obtaining patent protection for our products and technologies, defending our patents and preserving our trade secrets. We were previously involved in significant litigation to protect our patent position and may be required to engage in further litigation. In 2006, we settled a costly, six-year lawsuit against Mallinckrodt, Inc., part of Tyco Healthcare (currently Covidien Ltd.), and one of its subsidiaries, Nellcor Puritan Bennett, Inc., in which we claimed that Covidien was infringing some of our pulse oximetry signal processing patents.

In February 2009, we filed a patent infringement suit against Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH related to Philips FAST pulse oximetry technology and certain of Philips patient monitors as described in Part I, Item 3 of our Annual Report on Form 10-K, filed with the SEC on February 17, 2012, Part II, Item 1 of this Quarterly Report on Form 10-Q and Note 10 to the accompanying condensed consolidated financial statements. Both Philips Electronics North America Corporation and Philips Medizin Systeme Böblingen GmbH are associated with Philips Medical Systems, an OEM partner of ours. There is no guarantee that we will prevail in this suit or receive any damages or other relief if we do prevail.

We believe that other competitors of ours, including GE Medical Systems and Mindray Medical International Ltd., may be infringing at least one of our patents. Our failure to pursue any potential claim could result in the loss of our proprietary rights and harm our position in the marketplace. Therefore, we may be forced to pursue litigation to enforce our rights. Our ongoing and future litigation could result in significant additional costs and further divert the attention of our management and key personnel from our business operations and the implementation of our business strategy and may not be adequate to protect our intellectual property rights.

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**Risks Related to Our Regulatory Environment**

**Our failure to obtain and maintain FDA clearances or approvals on a timely basis, or at all, would prevent us from commercializing our current or upgraded products in the United States, which could severely harm our business.**

Each medical device that we wish to market in the U.S. generally must first receive either 510(k) clearance from the FDA pursuant to the Federal Food, Drug, and Cosmetic Act by filing a 510(k) pre-market notification, or PMA, through submitting a PMA application. Even if regulatory clearance or approval of a product is granted, the clearance or approval may be subject to limitations on the indicated uses for which the product may be marketed. We cannot assure you that the FDA will grant 510(k) clearance on a timely basis, if at all, for new products or uses that we propose for Masimo SET® or licensed rainbow® technology. The FDA's 510(k) clearance process of our products and uses has historically taken approximately four to six months. However, over the past year we have experienced a significantly longer 510(k) clearance review process. Our more recent experience in seeking FDA 510(k) clearance, along with information we have received from other medical device manufacturers, suggests that the FDA may have modified its 510(k) review protocol and process. Specifically, it appears that the FDA's medical device product reviews currently require applicants to provide much more information and data than in prior periods, the FDA is not consistently relying upon prior precedents thereby leading to more review cycles or, in some cases, to non-substantially equivalent decisions, and that the FDA has broadened the scope of its reviews. As a result, we have experienced lengthier FDA 510(k) review periods over the past 12 months, which has delayed the 510(k) clearance process for our products and uses over this period compared to prior periods. In addition, in September 2009, the FDA commissioned the Institute of Medicine to study the premarket notification program used to review and clear certain medical devices marketed in the U.S. It is believed that this study may result in formal changes to the FDA's 510(k) clearance review and approval processes which could potentially lengthen the review process of any future application of ours even further.

We have received FDA 510(k) clearance for the Pronto® and Pronto-7® for noninvasive spot-checking of hemoglobin and other measurements in clinical and non-clinical settings, including blood donation facilities. Before commercializing either device in U.S. blood donation centers, we are also pursuing specific regulatory clearance from the FDA Center for Biologics Evaluation and Research, which regulates the collection of blood and blood components used for transfusion or for the manufacture of pharmaceuticals derived from blood and blood components.

To date, the FDA has regulated pulse oximeters incorporating Masimo SET® and licensed rainbow® technology, and our sensors, cables and other products incorporating Masimo SET® and licensed rainbow® technology for pulse oximetry under the 510(k) process. Although 510(k) clearances have been obtained for all of our current products, these clearances may be withdrawn by the FDA at any time if substantial safety or effectiveness problems develop with our devices. Furthermore, our new products or significantly modified marketed products could be denied 510(k) clearance and be required to undergo the more burdensome PMA process. The process of obtaining PMA is much more costly, lengthy and uncertain than the process for obtaining 510(k) clearance and generally takes one to three years, but may be longer.

**The failure of our OEM partners to obtain required FDA clearances or approvals for products that incorporate our technologies could have a negative impact on our revenue.**

Our OEM partners will be required to obtain their own FDA clearances for products incorporating Masimo SET® and licensed rainbow® technology to market these products in the U.S. We cannot assure you that the FDA clearances we have obtained will make it easier for our OEM partners to obtain clearances of products incorporating these technologies, or that the FDA will ever grant clearances on a timely basis, if at all, for any future product incorporating Masimo SET® and licensed rainbow® technology that our OEM partners propose to market.

**If we or our suppliers fail to comply with ongoing regulatory requirements, or if we experience unanticipated problems with our products, these products could be subject to restrictions or withdrawal from the market.**

Our products, along with the manufacturing processes and promotional activities for such products, are subject to continual review and periodic inspections by the FDA and other regulatory bodies. In particular, we and our suppliers are required to comply with FDA's Quality System Regulation, or QSR, which covers the methods and documentation of the design, control testing, production, component suppliers control, quality assurance, labeling control, packaging, storage and shipping of our products. The FDA enforces the QSR through announced and unannounced inspections. We are also subject to similar state requirements and licenses. Failure by us or one of our suppliers to comply with statutes and regulations administered by the FDA and other regulatory bodies, discovery of

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previously unknown problems with our products (including unanticipated adverse events or adverse events of unanticipated severity or frequency), manufacturing problems, or failure to comply with regulatory requirements, or failure to adequately respond to any FDA observations concerning these issues, could result in, among other things, any of the following actions:

warning letters or untitled letters issued by the FDA;

finances, civil penalties, injunctions and criminal prosecution;

unanticipated expenditures to address or defend such actions;

delays in clearing or approving, or refusal to clear or approve, our products;

withdrawal or suspension of clearance or approval of our products or those of our third-party suppliers by the FDA or other regulatory bodies;

product recall or seizure;

orders for physician notification or device repair, replacement or refund;

interruption of production; and

operating restrictions.

Furthermore, our key component suppliers may not currently be, or may not continue to be, in compliance with applicable regulatory requirements. If any of these actions were to occur, it would harm our reputation and adversely affect our business, financial condition and results of operations.

### **Failure to obtain regulatory approval in foreign jurisdictions will prevent us from marketing our products abroad.**

We currently market and intend to continue to market our products internationally. Outside of the U.S., we can market a product only if we receive a marketing authorization and, in some cases, pricing approval, from the appropriate regulatory authorities. The regulatory registration/licensing process varies among international jurisdictions and may require additional testing. The time required for international registration of new products may differ from that required for obtaining FDA clearance. The foreign registration/licensing process may include all of the risks associated with obtaining FDA clearance in addition to other risks. We may not obtain foreign regulatory registration/licensing on a timely basis, if at all. FDA clearance does not ensure new product registration/licensing by foreign regulatory authorities. Approval by one foreign regulatory authority does not ensure approval by any other foreign regulatory authority or by the FDA. If we fail to receive necessary approvals to commercialize our products in foreign jurisdictions on a timely basis, or at all, our business, financial condition and results of operations could be adversely affected.

### **Modifications to our marketed devices may require new regulatory clearances or premarket approvals, or may require us to cease marketing or recall the modified devices until clearances or approvals are obtained.**

Any modifications to an FDA-cleared device that could significantly affect its safety or effectiveness or that would constitute a major change in its intended use would require a new 510(k) clearance or possibly a PMA approval. We may not be able to obtain such clearances or approvals

in a timely fashion, or at all. Delays in obtaining future clearances would adversely affect our ability to introduce new or enhanced products in a timely manner, which in turn would have an adverse effect on our business, financial condition and results of operations. We have made modifications to our devices in the past and we may make additional modifications in the future. If the FDA disagrees with our conclusion and requires new clearances or approvals for the modifications, we may be required to recall and to stop marketing the modified devices, which could have an adverse effect on our business, financial conditions and results of operations.

**Federal regulatory reforms may reduce the profit we are able to earn on the sale of our products.**

From time to time, legislation is drafted and introduced in Congress that could significantly change the statutory provisions governing the clearance or approval, manufacture and marketing of medical devices. In addition, FDA regulations and guidance are often revised or reinterpreted by the FDA in ways that may significantly affect our business and our products. It is impossible to predict whether legislative changes will be enacted or FDA regulations, guidance or interpretations changed, and what the impact of such changes, if any, may be. However, any changes could make it more difficult for us to maintain or attain approval to develop and commercialize our products and technologies.

**If our products cause or contribute to a death or serious injury, we will be subject to medical device reporting regulations, which can result in voluntary corrective actions or agency enforcement actions, including recall of our products.**

Under the FDA medical device reporting regulations, we are required to report to the FDA any incident in which a product of ours may have caused or contributed to a death or serious injury or in which a product of ours malfunctioned and, if the malfunction were to recur, would likely cause or contribute to death or serious injury. In addition, all manufacturers placing medical devices in European Union markets are legally required to report to the relevant authority in whose jurisdiction any serious or potentially serious incidents occurred involving devices produced or sold by the manufacturer.



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The FDA and similar foreign governmental authorities have the authority to require the recall of our commercialized products in the event of material deficiencies or defects in, for example, design, labeling or manufacture. In the case of the FDA, the authority to require a recall generally must be based on an FDA finding that there is a reasonable probability that the device would cause serious injury or death. Manufacturers may, under their own initiative, recall a product if any material deficiency in a device is found or we become aware of a safety issue involving a marketed product. A government-mandated or voluntary recall by us or by one of our distributors could occur as a result of component failures, manufacturing errors, design or labeling defects or other deficiencies and issues. We may initiate certain voluntary recalls involving our products in the future. Recalls of any of our products would divert managerial and financial resources and have an adverse effect on our financial condition and results of operations.

From our inception through September 29, 2012, we initiated five voluntary recalls of our products, none of which was material to our operating results. Each of these recalls was reported to the FDA within the appropriate regulatory timeframes. Because of our dependence upon patient and physician perceptions, any negative publicity associated with these or any future voluntary recalls could materially and adversely affect our business, financial condition, results of operations and growth prospects.

### **Off-label promotion of our products or promotional claims deemed false or misleading could subject us to substantial penalties.**

Obtaining 510(k) clearance only permits us to promote our products for the uses specifically cleared by the FDA. Use of a device outside its cleared or approved indications is known as off-label use. Physicians may use our products off-label because the FDA does not restrict or regulate a physician's choice of treatment within the practice of medicine. Although we may request additional cleared indications for our current products, the FDA may deny those requests, require additional expensive clinical data to support any additional indications or impose limitations on the intended use of any cleared product as a condition of clearance. We must have adequate substantiation for our product performance claims. If the FDA determines that we or our OEM partners have promoted our products for off-label use or have made false or misleading or inadequately substantiated promotional claims, it could request that we or our OEM partners modify those promotional materials or take regulatory or enforcement actions, including the issuance of an untitled letter, a warning letter, injunction, seizure, civil fine and criminal penalties. It is also possible that other federal, state or foreign enforcement authorities might take action if they consider our promotional or training materials to constitute promotion of an uncleared or unapproved use, which could result in significant fines or penalties under other statutory authorities, such as laws prohibiting false claims for reimbursement. In that event, we would be subject to extensive fines and penalties and our reputation could be damaged and adoption of our products would be impaired. Although our policy is to refrain from statements that could be considered off-label promotion of our products, the FDA or another regulatory agency could conclude that we have engaged in off-label promotion. In addition, the off-label use of our products may increase the risk of injury to patients, and, in turn, the risk of product liability claims. Product liability claims are expensive to defend and could divert our management's attention and result in substantial damage awards against us.

### **We may be subject to or otherwise affected by federal and state health care laws, including fraud and abuse and health information privacy and security laws, and could face substantial penalties if we are unable to fully comply with these laws.**

Although we do not provide health care services or receive payments directly from Medicare, Medicaid or other third-party payers for our products or the procedures in which our products are used, health care regulation by federal and state governments will impact our business. Health care fraud and abuse laws potentially applicable to our operations include, but are not limited to:

the Federal Health Care Programs Anti-Kickback Law, which prohibits, among other things, knowingly and willfully offering, paying, soliciting, or receiving any bribe, kickback or other remuneration intended to induce the purchase, order or recommendation of an item or service reimbursable under a federal health care program (such as the Medicare or Medicaid programs);

federal false claims laws which prohibit, among other things, knowingly and willfully presenting, or causing to be presented, claims for payment from Medicare, Medicaid, or other third-party payers that are false or fraudulent;

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the federal provisions of the HIPAA established federal crimes for knowingly and willfully executing a scheme to defraud any health care benefit program or making false statements in connection with the delivery of or payment for health care benefits, items or services; and

state laws analogous to each of the above federal laws, such as state anti-kickback and false claims laws that may apply to items or services reimbursed by non-governmental third-party payers, including commercial insurers, and state laws governing the privacy of certain PHI.

Federal and state false claims laws prohibit anyone from presenting, or causing to be presented, claims for payment to third-party payers that are false or fraudulent. For example, the federal Civil False Claims Act imposes liability on any person or entity who, among other things, knowingly and willfully presents, or causes to be presented, a false or fraudulent claim for payment by a federal health care program, including Medicaid and Medicare. Some suits filed under the Civil False Claims Act, known as *qui tam* actions, can be brought by a private individual, referred to as a whistleblower or relator, on behalf of the government and such individuals may share in any amounts paid by the entity to the government in fines or settlement. Such complaints are filed under seal and remain sealed until the applicable court orders otherwise. In recent years, the number of suits brought by private individuals has increased dramatically. Manufacturers, like us, can be held liable under false claims laws, even if they do not submit claims to the government, if they are found to have caused medical care providers to have submitted claims to the government for payment for a service or the use of a device that is not properly covered for government reimbursement. A number of states also have false claims laws, and some of these laws may apply to claims for items or services reimbursed under Medicaid and/or commercial insurance. Sanctions under these federal and state laws may include civil monetary penalties, exclusion of a manufacturer's products from reimbursement under government programs and imprisonment. In particular, when an entity is determined to have violated the federal Civil False Claims Act, it may be required to pay up to three times the actual damages sustained by the government, plus civil penalties of \$5,500 to \$11,000 for each separate false claim. As previously disclosed, in November 2010 we voluntarily notified the FDA that we received allegations regarding the safety and efficacy of our Pronto® and Pronto-7® products from certain former sales representatives of ours. In April 2011, we were informed by representatives of the U.S. Department of Justice, or DOJ, that a *qui tam* complaint had been filed under seal against us by certain individuals. We cooperated fully with the government's investigation and in November 2011, we were informed that the DOJ declined to intervene in the case. Although we believe that our business practices comply in all material respects with applicable laws and regulations, complaints filed against us and any related government investigations may involve some distraction to management and cause us to incur additional expenses.

We have certain arrangements with hospitals that may be affected by these laws. For instance, under our standard customer arrangements, we provide hospitals with free pulse oximetry monitoring devices in exchange for their agreement to purchase future pulse oximetry sensor requirements from us. In addition, we occasionally provide our customers with rebates in connection with their annual purchases. While we believe that these arrangements are structured such that we are currently in compliance with applicable federal and state health care laws, one or more of these arrangements may not meet the Federal Anti-Kickback Law's safe harbor requirements, which may result in increased scrutiny by government authorities that are responsible for enforcing these laws.

There can be no assurance that we will not be found to be in violation of any of such laws or other similar governmental regulations to which we are directly or indirectly subject, and as a result we may be subject to penalties, including civil and criminal penalties, damages, fines, exclusion of our products from reimbursement under Medicare, Medicaid and other federal health care programs, and the curtailment or restructuring of our operations. Any penalties could adversely affect our ability to operate our business and our financial results. Any action against us for violation of these laws, even if we successfully defend against them, could cause us to incur significant legal expenses and divert our management's attention from the operation of our business.

Further, we are required to comply with federal and state laws governing the transmission, security and privacy of individually identifiable PHI that we may obtain or have access to in connection with manufacture and sale of our products. We may be required to make costly system modifications to comply with the HIPAA privacy and security requirements. Our failure to comply may result in criminal and civil liability because the potential for enforcement action against business associates is greater as a result of the Health Information Technology for Economic and Clinical Health Act.

Numerous other federal and state laws protect the confidentiality of PHI including state medical information privacy laws, state social security number protection laws and state and federal consumer protection laws. In some cases, more protective state privacy and security laws are not preempted by HIPAA and may be subject to interpretation by various governmental authorities and courts resulting in potentially complex compliance issues for us and our customers.

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State and federal human subject protection laws apply to our receipt of individually identifiable PHI in connection with clinical research. These laws could create liability for us if one of our research collaborators uses or discloses research subject information without authorization and in violation of applicable laws.

**Legislative and regulatory changes in the health care industry could have a negative impact on our financial performance. Furthermore, our business, financial condition, results of operations and cash flows could be significantly and adversely affected by recently enacted health care reform legislation in the U.S. or if reform programs are adopted in our key markets.**

Changes in the health care industry in the U.S. and elsewhere could adversely affect the demand for our products as well as the way in which we conduct our business. Significantly, President Obama signed health care reform legislation into law that will require most individuals to have health insurance, establish new regulations on health plans, and create insurance pooling mechanisms and other expanded public health care measures. This legislation also will reduce Medicare spending on services provided by hospitals and other providers and, after December 31, 2012, impose a 2.3% tax on the sale of a taxable medical device in the U.S. by the manufacturer, producer or importer. Our operating expenses resulting from this excise tax and results of operations will be materially and adversely affected, if we are unable to pass the excise tax onto our customers.

Many details of the recently enacted health care reform legislation will be addressed in the implementing regulations. We cannot predict the effect any future legislation or regulation will have on us or what health care initiatives, if any, will be implemented at the state level.

In general, an expansion in government's role in the U.S. health care industry may lower reimbursements for our products, reduce demand for innovative products, reduce medical procedure volumes and adversely affect our business and results of operations, possibly materially. In addition, as a result of the focus on health care reform in connection with the 2012 presidential election, there is risk that Congress may implement changes in laws and regulations governing health care service providers, including measures to control costs, or reductions in reimbursement levels.

Furthermore, many private payers look to Medicare's coverage and reimbursement policies in setting their coverage policies and reimbursement amounts such that federal reforms could influence the private sector as well. Finally, many states also may attempt to reform their Medicaid programs such that either coverage for certain items or services may be narrowed or reimbursement for them could be reduced. These health care reforms may adversely affect our business.

Consistent with or in addition to Congressional or state reforms, the CMS, the federal agency that administers the Medicare and Medicaid programs, could change its current policies that affect coverage and reimbursement for our products. CMS determined in 2007 that certain uses of pulse oximetry monitoring are eligible for separate Medicare payment in the hospital outpatient setting when no separately payable hospital outpatient services are reported on the same date of service. Each year, however, CMS re-examines the reimbursement rates for hospital inpatient and outpatient and physician office settings and could either increase or decrease the reimbursement rate for procedures utilizing our products. We are unable to predict when legislation or regulation that affects our business may be proposed or enacted in the future or what effect any such legislation or regulation would have on our business. Any such legislation, regulation or policies that affect the coverage and reimbursement of our current or future products, or the procedures utilizing our current or future products, could cause our sales to decrease and our revenue to decline.

In addition, the requirements or restrictions imposed on us or our products may change, either as a result of administratively adopted policies or regulations or as a result of the enactment of new laws. There may be heightened scrutiny by federal and state regulators and legislators of the FDA's device approval process, the agency's efforts to assure the safety of marketed devices, and physician payments and promotional activities by manufacturers. Any new regulations or statutory provisions could result in delays or increased costs during the period of product development, clinical trials, and regulatory review and approval, as well as increased costs to assure compliance.

Further, our success in international markets also depends upon the eligibility of reimbursement for our products through government-sponsored health care payment systems and other third-party payers. Outside of the U.S., reimbursement systems vary by country. These systems are often subject to the same pressures to curb rising health care costs and control health care expenditures as those in the U.S. In addition, as economies of emerging markets develop, these countries may implement changes in their health care delivery and payment systems. If adequate levels of reimbursement from third-party payers outside of the U.S. are not obtained, sales of our products outside of the U.S. may be adversely affected.

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**Risks Related to Our Business and Operations**

**Cercacor has conducted most of the research and development of rainbow<sup>®</sup> technology and we are largely dependent upon Cercacor to develop improvements to certain rainbow<sup>®</sup> technologies.**

Cercacor has conducted the substantial majority of research and development of certain rainbow<sup>®</sup> technologies. Although we expect Cercacor to continue its research and development activities related to certain rainbow<sup>®</sup> technology and specific noninvasive monitoring measurements, including blood glucose and hemoglobin, we have no assurance that it will do so. In the event Cercacor does not continue to develop and improve selected rainbow<sup>®</sup> technologies, our business, financial condition and results of operations could be adversely affected.

**We may experience conflicts of interest with Cercacor with respect to business opportunities and other matters.**

Prior to our initial public offering in August 2007, our stockholders owned 99% of the outstanding shares of capital stock of Cercacor and we believe that as of September 29, 2012, a number of stockholders of Cercacor continued to own shares of our stock. Joe Kiani, our Chairman and Chief Executive Officer, is also the Chairman and Chief Executive Officer of Cercacor.

Jack Lasersohn, another member of our board of directors, also serves on the board of directors of Cercacor. Due to the interrelated nature of Cercacor with us, conflicts of interest will arise with respect to transactions involving business dealings between us and Cercacor, potential acquisitions of businesses or products, development of products and technology, the sale of products, markets and other matters in which our best interests and the best interests of our stockholders may conflict with the best interests of the stockholders of Cercacor. We cannot assure you that any conflict of interest will be resolved in our favor, or that with respect to our transactions with Cercacor we will negotiate terms that are as favorable to us as if such transactions were with another third party.

**We will be required to pay Cercacor for the right to use certain improvements to Masimo SET<sup>®</sup> that we develop.**

Under the Cross-Licensing Agreement, if we develop improvements to Masimo SET<sup>®</sup> for the noninvasive monitoring of non-vital signs parameters, we would be required to assign these developments to Cercacor and then license the technology back from Cercacor in consideration for royalty obligations to Cercacor. Therefore, any improvement to this technology would be treated as if it had been developed exclusively by Cercacor. In addition, we will not be reimbursed by Cercacor for our expenses relating to the development of any such technology. As a result of these terms, we may not generate any revenue from the further development of Masimo SET<sup>®</sup> for the monitoring of non-vital signs parameters, which could adversely affect our business, financial condition and results of operations.

**We are required to pay royalties to Cercacor for all products sold that contain rainbow<sup>®</sup> technology, including certain annual minimum royalty payments, and this may impact our reported gross margins if we discontinue consolidating Cercacor within our financial statements.**

The Cross-Licensing Agreement requires us to pay Cercacor a royalty for all products that we sell which include their proprietary rainbow<sup>®</sup> technology. This includes handheld, table-top and multi-parameter products that incorporate licensed rainbow<sup>®</sup> technology. Beginning in 2009, for hospital contracts where we place equipment and enter into a sensor contract, we will pay a royalty to Cercacor on the total sensor contract revenue based on the ratio of rainbow<sup>®</sup> enabled devices to total devices. The agreement also requires that we make available to Cercacor, at its request, up to 10% of our annual board and sensor production volume at our total manufactured cost. In addition to these specific royalty and product obligations, our Cross-Licensing Agreement requires that we pay Cercacor specific annual minimum royalty payments.

Currently, we are required to consolidate Cercacor within our financial statements. Accordingly, the royalties that we owe to Cercacor are eliminated in our condensed consolidated financial statements presented within this Quarterly Report on Form 10-Q and our other periodic reports and the gross profit margins reported in our consolidated financial results do not include the royalty expense that we pay to Cercacor. We are also obligated to include, and have included, Cercacor's engineering and administrative expenses in our reported engineering and administrative expenses. If our financial statements were not consolidated with Cercacor, our reported cost of goods sold would increase and our reported engineering and administrative expenses would decrease. To date, the amount of royalty expense has approximated the amount of engineering and administrative expense. In the future, depending upon the success of rainbow<sup>®</sup> products and the royalties earned by Cercacor on those revenues, it is possible that the royalty expense will grow at a rate higher than the growth of engineering and administrative expenses. Should this occur, and if we were not required to consolidate Cercacor's financial results within our financial statements, then our unconsolidated cost of sales could grow at a faster rate than our unconsolidated engineering expenses.

Despite describing and reflecting this Cercacor consolidation requirement within our financial statements, failure to understand or appreciate the significance of our consolidation of Cercacor's financial statements may lead current and prospective investors to draw inaccurate perspectives

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and conclusions regarding our historical and future financial condition and results of operations.

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**In the event that the Cross-Licensing Agreement is terminated for any reason, or Cercacor grants a license to rainbow® technology to a third party, our business would be materially and adversely affected.**

Cercacor owns all of the proprietary rights to rainbow® technology developed with our proprietary Masimo SET® for products intended to be used in the Cercacor Market, and all rights for any non-vital signs measurement for which we do not exercise an option pursuant to the Cross-Licensing Agreement. In addition, Cercacor has the right to terminate the Cross-Licensing Agreement or grant licenses covering rainbow® technology to third parties if we breach certain terms of the agreement, including any failure to meet our minimum royalty payment obligations or failure to use commercially reasonable efforts to develop or market products incorporating licensed rainbow® technology. If we lose our exclusive license to rainbow® technology, we would lose the ability to prevent others from making, using, selling or importing products using rainbow® technology in our market. As a result, we would likely be subject to increased competition within our market, and Cercacor or competitors who obtain a license to rainbow® technology from Cercacor would be able to offer related products.

**We may not be able to commercialize our products incorporating licensed rainbow® technology cost-effectively or successfully.**

It is generally more expensive for us to make products that incorporate rainbow® technology that we license than products that do not include licensed rainbow® technology, due to increased royalties that we must pay to Cercacor for the licenses. We cannot assure you that we will be able to sell products incorporating licensed rainbow® technology at a price the market is willing to accept. If we cannot commercialize our products incorporating licensed rainbow® technology successfully, we may not be able to generate sufficient product revenue from these products to be profitable, which could adversely affect our business, financial condition and results of operations.

**Rights provided to Cercacor in the Cross-Licensing Agreement may impede a change in control of our company.**

In the event we undergo a change in control, we are required to immediately pay a \$2.5 million fee to exercise an option to license technology developed by Cercacor for use in blood glucose monitoring. Under the Cross-Licensing Agreement, a change in control includes, but is not limited to, the resignation or termination of Joe Kiani from his position of Chief Executive Officer of either Masimo or Cercacor. Additionally, our per product royalties payable to Cercacor will become subject to specified minimums, and the minimum aggregate annual royalties for all licensed rainbow® measurements payable to Cercacor is \$15.0 million for carbon monoxide, methemoglobin, fractional arterial oxygen saturation, hemoglobin and blood glucose, plus up to \$2.0 million per other rainbow® measurements. Also, if the surviving or acquiring entity ceases to use Masimo as a company name and trademark following a change in control, all rights to the Masimo trademark will automatically be assigned to Cercacor. This could delay or discourage transactions involving an actual or potential change in control of us, including transactions in which our stockholders might otherwise receive a premium for their shares over our then-current trading price. In addition, our requirement to assign all future improvements for non-vital signs to Cercacor could impede a change in control of our company.

**We may experience significant fluctuations in our quarterly results in the future and we may not maintain our recent profitability and changes to existing accounting pronouncements or taxation rules may affect how we conduct our business and affect our reported results of operations.**

Our operating results have fluctuated in the past and are likely to fluctuate in the future. We may experience fluctuations in our quarterly results of operations as a result of:

delays or interruptions in manufacturing and shipping of our products;

varying demand for and market acceptance of our technologies and products;

the effect of competing technological and market developments resulting in lower selling prices or significant promotional costs;

changes in the timing of product orders and the volume of sales to our OEM partners;

actions taken by GPOs;

delays in hospital conversions to our products and declines in hospital patient census;

our legal expenses, particularly those related to litigation matters;

changes in our product or customer mix;

inability to efficiently scale operations and establish processes to accommodate business growth;

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unanticipated delays or problems in the introduction of new products, including delays in obtaining clearance or approval from the FDA;

high levels of returns and repairs; and

change in reimbursement rates for SpHb<sup>®</sup>, SpCO<sup>®</sup> and SpMet<sup>®</sup> parameters.

If our operating results fail to meet or exceed the expectations of securities analysts or investors, our stock price could drop suddenly and significantly. Our expense levels are based, in part, on our expectations regarding future revenue levels and are relatively fixed in the short term. As a result, if our revenue for a particular period was below our expectations, we would not be able to proportionately reduce our operating expenses for that period. Any revenue shortfall would have a disproportionately negative effect on our operating results for the period. Due to these and other factors, you should not rely on our results for any one quarter as an indication of our future performance.

In addition, a change in accounting pronouncements or taxation rules or practices, or the interpretation of them by the SEC or other regulatory bodies, can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. New accounting pronouncements or taxation rules and varying interpretations of accounting pronouncements or taxation practice have occurred and may occur in the future. Changes to existing rules or the adoption of new rules may adversely affect our reported financial results or the way we conduct our business.

**If we lose the services of our key personnel, or if we are unable to attract and retain other key personnel, we may not be able to manage our operations or meet our growth objectives.**

We are highly dependent on our senior management, especially Joe Kiani, our Chief Executive Officer, and other key officers. We are also heavily dependent on our engineers and field sales team, including sales representatives and clinical specialists. Our success will depend on our ability to retain our current management, engineers and field sales team, and to attract and retain qualified personnel in the future, including scientists, clinicians, engineers and other highly skilled personnel. Competition for senior management, engineers and field sales personnel is intense and we may not be able to retain our personnel. In addition, some of our key personnel hold stock options with an exercise price that is greater than our recent closing prices, which may minimize the retention value of these options. The loss of the services of members of our key personnel could prevent the implementation and completion of our objectives, including the development and introduction of our products. In general, our officers may terminate their employment at any time without notice for any reason. We carry key person life insurance on only Mr. Kiani, who is also the Chief Executive Officer of Cercacor. Mr. Kiani devotes most of his time to us.

**\* Existing or future acquisitions of businesses could negatively affect our business, financial condition and results of operations if we fail to integrate the acquired businesses successfully into our existing operations or if we discover previously undisclosed liabilities.**

We have acquired six businesses since our inception and we may acquire additional businesses in the future. Successful acquisitions depend upon our ability to identify, negotiate, complete and integrate suitable acquisitions and to obtain any necessary financing. Even if we complete acquisitions, we may experience:

difficulties in integrating any acquired companies, personnel, products and other assets into our existing business;

delays in realizing the benefits of the acquired company, products or other assets;

diversion of our management's time and attention from other business concerns;

limited or no direct prior experience in new markets or countries we may enter;



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higher costs of integration than we anticipated;

difficulties in retaining key employees of the acquired business who are necessary to manage these acquisitions; and

changes in the overall financial model as certain acquired companies may have a different revenue, gross profit margin or operating expense profile.

In addition, an acquisition could materially impair our operating results by causing us to incur debt or requiring us to amortize acquisition expenses and acquired assets. We may also discover deficiencies in internal controls, data adequacy and integrity, product quality, regulatory compliance and product liabilities that we did not uncover prior to our acquisition of such businesses, which could result in us becoming subject to penalties or other liabilities. Any difficulties in the integration of acquired businesses or unexpected penalties or liabilities in connection with such businesses could have a material adverse effect on our business, financial condition and results of operations.

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In 2012, we have acquired two operating businesses that will require time and costs to integrate into the Masimo organizational structure. While we have been successful in our ability to integrate prior acquisitions, the two 2012 acquisitions involve larger organizations, and as a result, there can be no assurances that we will be able to effectively integrate two acquisitions during the same fiscal year. Any difficulties in the integration of acquired businesses or unexpected penalties or liabilities in connection with such acquisitions could have a material adverse effect on our business, financial condition and results of operations.

### **Our international business structure may not result in expected operational benefits.**

In 2008, we implemented a new international business structure designed to better serve and support our growing international business. By centralizing our international operations, including sales management, marketing, customer support, planning, logistics and administrative functions, we believe we will be able to develop a more efficient and scalable international organization capable of being even more responsive to the business needs of our international customers all under one centralized management structure. We commenced the implementation of an international business structure to align our operations with the business needs of our non-U.S. customers and we believe that we may, in the long run, also benefit from certain operational benefits and achieve a lower overall tax rate. However, there can be no assurance that our efforts will produce any anticipated operational benefits or provide an overall lower tax rate. Realization of the expected benefits will depend on a number of factors, including our future business results and profitability, changes in U.S. or international tax law and the geographic composition of our pre-tax income. Legislative action may be taken by the U.S. Congress which, if ultimately enacted, could adversely affect our effective tax rate and/or require us to take further action, at potentially significant expense, to seek to preserve our effective tax rate. We cannot predict the outcome of any specific legislative proposals. However, if proposals were enacted that had a negative effect on our international business structure, we could be subjected to increased taxation and/or potentially significant expense.

### **\* The risks inherent in operating internationally and the risks of selling and shipping our products and of purchasing our components and products internationally may adversely impact our business, financial condition and results of operations.**

We derive a portion of our net sales from international operations. In each of the three and nine months ended September 29, 2012, 29.3% and 28.4% of our product revenue was derived from our international operations. In addition, we purchase a portion of our raw materials and components on the international market. The sale and shipping of our products across international borders, as well as the purchase of materials and components from international sources, subject us to extensive U.S. and foreign governmental trade regulations. Compliance with such regulations is costly and we would be exposed to potentially significant penalties for non-compliance. Any failure to comply with applicable legal and regulatory obligations could impact us in a variety of ways that include, but are not limited to, significant criminal, civil and administrative penalties, including imprisonment of individuals, fines and penalties, denial of export privileges, seizure of shipments, restrictions on certain business activities, and exclusion or debarment from government contracting. Also, the failure to comply with applicable legal and regulatory obligations could result in the disruption of our shipping, manufacturing and sales activities. Any material decrease in our international sales would adversely affect our business, financial condition and results of operations.

In addition, our international sales operations expose us and our representatives, agents and distributors to risks inherent in operating in foreign jurisdictions. These risks include, but are not limited to:

the imposition of additional U.S. and foreign governmental controls or regulations;

the imposition of costly and lengthy new export licensing requirements;

a shortage of high-quality sales people and distributors;

loss of any key personnel that possess proprietary knowledge, or who are otherwise important to our success in certain international markets;

changes in duties and tariffs, license obligations and other non-tariff barriers to trade;

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the imposition of new trade restrictions;

the imposition of restrictions on the activities of foreign agents, representatives and distributors;

scrutiny of foreign tax authorities which could result in significant fines, penalties and additional taxes being imposed on us;

pricing pressure that we may experience internationally;

laws and business practices favoring local companies;

political instability and actual or anticipated military or political conflicts;

financial and civil unrest worldwide;

longer payment cycles; and

difficulties in enforcing or defending intellectual property rights.

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In addition, the U.S. Foreign Corrupt Practices Act and similar worldwide anti-bribery laws in non-U.S. jurisdictions generally prohibit companies and their intermediaries from making improper payments to non-U.S. officials for the purpose of obtaining or retaining business. Because of the predominance of government-sponsored health care systems around the world, many of our customer relationships outside of the U.S. are with governmental entities and are therefore subject to such anti-bribery laws. Our policies mandate compliance with these anti-bribery laws. Despite our training and compliance programs, our internal control policies and procedures may not always protect us from reckless or criminal acts committed by our employees or agents. Violations of these laws, or allegations of such violations, could subject us to cash and non-cash penalties, disrupt our operations, involve significant management distraction and result in a material adverse effect on our business, financial condition and results of operations.

**\* Our operations may be adversely impacted by our exposure to risks related to foreign currency exchange rates.**

We market our products in certain foreign markets through our subsidiaries and other international distributors. The related sales agreements may provide for payments in a foreign currency. A majority of our sales and expenditures are transacted in U.S. dollars. We transact with foreign customers in currencies other than the U.S. dollar. These foreign currency revenues, when converted into U.S. dollars, can vary depending on average exchange rates during a respective period. In addition, we are exposed to foreign currency gains or losses on outstanding foreign currency denominated receivables. When converted to U.S. dollars, these receivables can vary depending on the monthly exchange rates at the end of the period. Certain of our foreign sales support subsidiaries transact in their respective country's local currency, which is also their functional currency. As a result, expenses of these foreign subsidiaries when converted into U.S. dollars can vary depending on average monthly exchange rates during a respective period. Certain intercompany transactions may give rise to realized and unrealized foreign currency gains or losses. Accordingly, our operating results are subject to fluctuations in foreign currency exchange rates.

The balance sheets of our foreign subsidiaries whose functional currency is not the U.S. dollar are translated into U.S. dollars at the rate of exchange at the balance sheet date and the statements of comprehensive income and cash flows are translated into U.S. dollars using the average monthly exchange rate during the period. Any foreign exchange gain or loss as a result of translating the balance sheets of our foreign subsidiaries whose functional currency is not the U.S. dollar is included in equity as a component of accumulated other comprehensive income.

If we decide in the future to hedge our foreign currency exchange rate risk by entering into forward contracts, these contracts may not mitigate the potential adverse impact on our financial results due to the variability of timing and amount of payments under these contracts. In addition, our failure to sufficiently hedge, forecast or otherwise manage such foreign currency risks properly could have a material adverse effect on our business, financial condition and results of operations.

**We currently manufacture our products at two locations and any disruption in or expansion of our manufacturing operations could adversely affect our business, financial condition and results of operations.**

We rely on our manufacturing facilities in Mexicali, Mexico and Irvine, California. These facilities and the manufacturing equipment we use to produce our products would be difficult to replace and could require substantial time to repair. Our facilities may be affected by natural or man-made disasters. Earthquakes are of particular significance since both of our facilities are located in an earthquake-prone area. We are also vulnerable to damage from other types of disasters, including power loss, attacks from extremist or terrorist organizations, epidemics, communication failures, fire, floods and similar events. In the event that one of our facilities was affected by a natural or man-made disaster, we would be forced to rely on third-party manufacturers if we could not shift production to our other manufacturing facility. Our insurance for damage to our property and the disruption of our business from casualties may not be sufficient to cover all of our potential losses and may not continue to be available to us on acceptable terms, or at all. If we are forced to seek alternative facilities, or if we voluntarily expand one or more of our manufacturing operations to new locations, we may incur additional transition costs and we may experience a disruption in the supply of our products until the new facilities are available and operating. We are also vulnerable to disruptions which may occur as a result of local, regional and worldwide health risks. Such disruptions may include the inability to manufacture and distribute our products due to the direct effects of illness on individuals or due to constraints on supply and distribution that may result from either voluntary or government imposed restrictions. Any disruption

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or delay at our manufacturing facilities and any expansion of our operations to additional locations could create operational hurdles and have an adverse impact on our ability to produce sufficient inventory of our products or may require us to incur additional expenses in order to produce sufficient inventory. In addition, any disruption, delay, transition or expansion of our manufacturing operations could impair our ability to meet the demand of our customers and our customers may cancel orders or purchase products from our competitors, which could adversely affect our business, financial condition and results of operations.

### **Our suppliers may not supply us with a sufficient amount of materials and components or materials and components of adequate quality.**

We depend on sole or limited source suppliers for key materials and components of our noninvasive blood constituent patient monitoring solutions, and if we are unable to obtain these components on a timely basis, we will not be able to deliver our noninvasive blood constituent patient monitoring solutions to customers. Also, we cannot guarantee that any of the materials or components that we purchase, if available at all, will be of adequate quality. From time to time, there are industry-wide shortages of several electronic components that we use in our noninvasive blood constituent patient monitoring solutions. We may experience delays in production of our products if we fail to identify alternate vendors for materials and components, or any parts supply is interrupted or reduced or there is a significant increase in production costs, each of which could adversely affect our business, financial condition and results of operations.

### **If we fail to comply with the reporting obligations of the Securities Exchange Act of 1934 and Section 404 of the Sarbanes-Oxley Act of 2002, or if we fail to maintain adequate internal control over financial reporting, our business, results of operations and financial condition and investors' confidence in us could be materially and adversely affected.**

As a public company, we are required to comply with the periodic reporting obligations of the Securities Exchange Act of 1934, as amended, or the Exchange Act, including preparing annual reports, quarterly reports and current reports. Our failure to prepare and disclose this information in a timely manner and meet our reporting obligations in their entirety could subject us to penalties under federal securities laws and regulations of The Nasdaq Stock Market LLC expose us to lawsuits and restrict our ability to access financing on favorable terms, or at all.

In addition, pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, as amended, or the Sarbanes-Oxley Act, we are required to evaluate and provide a management report of our systems of internal control over financial reporting and our independent registered public accounting firm is required to attest to, our internal control over financial reporting. During the course of the evaluation of our internal control over financial reporting, we may identify areas requiring improvement and may be required to design enhanced processes and controls to address issues identified through this review. This could result in significant delays and costs to us and require us to divert substantial resources, including management time from other activities. In addition, if we fail to maintain the adequacy of our internal controls over financial reporting, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal control over financial reporting in accordance with the Sarbanes-Oxley Act. Moreover, effective internal controls are necessary for us to produce reliable financial reports and are important to help prevent fraud. Any failure to maintain the requirements of Section 404 on a timely basis could result in the loss of investor confidence in the reliability of our financial statements, which in turn could harm our business, negatively impact the trading price of our stock, and adversely affect investors' confidence in our company and our ability to access capital markets for financing.

### **Changing laws and increasingly complex corporate governance and public disclosure requirements could have an adverse effect on our business and operating results.**

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act, the Dodd-Frank Wall Street Reform and Consumer Protection Act, new regulations of the SEC and The Nasdaq Stock Market LLC, have and will create additional compliance requirements for companies such as ours. To maintain high standards of corporate governance and public disclosure, we have invested, and intend to continue to invest, in reasonably necessary resources to comply with evolving standards. These investments have resulted in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities and may continue to do so in the future.

### **If product liability claims are brought against us, we could face substantial liability and costs.**

The manufacture and sale of products using Masimo SET<sup>®</sup> and licensed rainbow<sup>®</sup> technology expose us to product liability claims and product recalls, including, but not limited to, those that may arise from unauthorized off-label use, which is use of a device in a manner outside the measurement or measurements cleared by the FDA, or malfunction of, or design flaws or manufacturing defects in, our products or the use of our products with incompatible components or systems. Any losses that we may suffer from product liability claims, and the effect that any product liability litigation may have upon the reputation and marketability of our technology



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and products, together with the corresponding diversion of the attention of our key employees, may subject us to significant damages and could adversely affect our business, financial condition and results of operations. We cannot be certain that our product liability insurance will be sufficient to cover any or all damages or claims. Furthermore, we may not be able to obtain or maintain insurance in the future at satisfactory rates or in adequate amounts to protect us against any product liability claims.

### **We may incur environmental and personal injury liabilities related to certain hazardous materials used in our operations.**

Our manufacturing processes involve the use, generation and disposal of certain hazardous materials and wastes, including silicone adhesives, solder and solder paste, sealants, epoxies and various solvents such as methyl ethyl ketone, acetone and isopropyl alcohol. As a result, we are subject to stringent federal, state and local laws relating to the protection of the environment, including those governing the use, handling and disposal of hazardous materials and wastes. We may incur significant costs to comply with environmental regulations.

From time to time new regulations are enacted, and it is difficult to anticipate how such regulations will be implemented and enforced. We continue to evaluate the necessary steps for compliance with environmental regulations as they are enacted. Future environmental laws may significantly affect our operations because, for instance, our manufacturing processes may be required to be altered or we may be required to use different types of materials in manufacturing our products, which may increase our manufacturing costs, detrimentally impact the performance of our products, add greater testing lead-times for product introductions or have other similar effects. In our research and manufacturing activities, we use, and our employees, may be exposed to, materials that are hazardous to human health, safety or the environment. These materials and various wastes resulting from their use are stored at our facility pending ultimate use and disposal. The risk of accidental injury, including to our employees, or contamination from these materials cannot be eliminated. In the event of such an accident, we could be held liable for any resulting damages and any such liability could exceed our reserves. Although we maintain general liability insurance, we do not specifically insure against environmental liabilities. If an enforcement action were to occur, our reputation and our business and financial condition may be harmed, even if we were to prevail or settle the action on terms favorable to us.

### **We rely significantly on information technology and any failure, inadequacy, interruption or security lapse of that technology, including any cybersecurity incidents, could harm our ability to operate our business effectively.**

Our ability to manage and maintain our internal reports effectively, and to ship products to customers and invoice them on a timely basis depends significantly on our enterprise resource planning system and other information systems. Portions of our information technology systems may experience interruptions, delays or cessations of service or produce errors in connection with ongoing systems implementation work. Cybersecurity attacks in particular are evolving and include, but are not limited to, malicious software, attempts to gain unauthorized access to data and other electronic security breaches that could lead to disruptions in systems, misappropriation of our confidential or otherwise protected information and corruption of data. The failure of these systems to operate effectively or to integrate with other systems, or a breach in security or other unauthorized access of these systems, may also result in delays in product fulfillment and reduced efficiency of our operations, and could require significant capital investments to remediate any such failure, problem or breach, all of which could adversely affect our business, financial condition and results of operations.

## **Risks Related to Our Stock**

### **\* Our stock price may be volatile, and your investment in our stock could suffer a decline in value.**

There has been significant volatility in the market price and trading volume of equity securities, which is often unrelated to the financial performance of the companies issuing the securities. These broad market fluctuations may negatively affect the market price of our stock. From July 1, 2012 to September 29, 2012, our closing stock price ranged from \$21.00 to \$24.87. You may not be able to resell your shares at or above the price you paid for them due to fluctuations in the market price of our stock caused by changes in our operating performance or prospects and other factors.

Some specific factors, in addition to the other risk factors identified above, may have a significant effect on our stock market price, many of which we cannot control. These include but are not limited to:

actual or anticipated fluctuations in our operating results or future prospects;

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our announcements or our competitors' announcements of new products;

the public's reaction to our press releases, our other public announcements and our filings with the SEC;

strategic actions by us or our competitors, such as acquisitions or restructurings;

new laws or regulations or new interpretations of existing laws or regulations applicable to our business;



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changes in accounting standards, policies, guidance, interpretations or principles;

changes in our growth rates or our competitors' growth rates;

developments regarding our patents or proprietary rights or those of our competitors;

ongoing legal proceedings;

our inability to raise additional capital as needed;

concerns or allegations as to the safety or efficacy of our products;

changes in financial markets or general economic conditions;

sales of stock by us or members of our management team, our board of directors or certain institutional stockholders; and

changes in stock market analyst recommendations or earnings estimates regarding our stock, other comparable companies or our industry generally.

**\* Concentration of ownership among our existing directors, executive officers and principal stockholders may prevent new investors from influencing significant corporate decisions.**

As of September 29, 2012, our current directors and executive officers and their affiliates, in the aggregate, beneficially owned 13.2% of our outstanding stock. Subject to any fiduciary duties owed to our other stockholders under Delaware law, the stockholders may be able to exercise a significant influence over matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, and will have some control over our management and policies. Some of these persons or entities may have interests that are different from yours. For example, these stockholders may support proposals and actions with which you may disagree or which are not in your best interests. The concentration of ownership could delay or prevent a change in control of us or otherwise discourage a potential acquirer from attempting to obtain control of us, which in turn could reduce the price of our stock. In addition, these stockholders could use their voting influence to maintain our existing management and directors in office, delay or prevent changes in control of us, or support or reject other management and board proposals that are subject to stockholder approval, such as amendments to our employee stock plans and approvals of significant financing transactions.

**\* You could experience substantial dilution of your investment as a result of subsequent exercises of our outstanding options or the grant of future equity awards by us.**

As of September 29, 2012, an aggregate of 13.4 million shares of our stock were reserved for future issuance under our three equity incentive plans, 8.4 million of which were subject to options outstanding as of that date at a weighted average exercise price of \$22.76 per share. To the extent outstanding options are exercised, our existing stockholders may incur dilution. We rely heavily on equity awards to motivate current employees and to attract new employees. The grant of future equity awards by us to our employees and other service providers may further dilute our stockholders.

**Future resales of our stock, including those by our insiders and a few investment funds, may cause our stock price to decline.**

A significant portion of our outstanding shares are held by directors, executive officers and a few investment funds. Resale by these stockholders of a substantial number of shares, announcements of the proposed resale of substantial amounts of our stock or the perception that substantial resales may be made, could significantly reduce the market price of our stock. Some of our directors and executive officers have entered into

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Rule 10b5-1 trading plans pursuant to which they have arranged to sell shares of our stock from time to time in the future. Generally, these sales require public filings. Actual or potential sales by these insiders, including those under a pre-arranged Rule 10b5-1 trading plan, could be interpreted by the market as an indication that the insider has lost confidence in our stock and reduce the market price of our stock.

We have registered and expect to continue to register shares reserved under our equity plans under a Registration Statement on Form S-8. All shares issued pursuant to a Registration Statement on Form S-8 can be freely sold in the public market upon issuance, subject to restrictions on our affiliates under Rule 144. If a large number of these shares are sold in the public market, the sales could reduce the trading price of our stock.

**Our corporate documents and Delaware law contain provisions that could discourage, delay or prevent a change in control of our company, prevent attempts to replace or remove current management and reduce the market price of our stock.**

Provisions in our amended and restated certificate of incorporation and amended and restated bylaws may discourage, delay or prevent a merger or acquisition involving us that our stockholders may consider favorable. For example, our amended and restated certificate of incorporation authorizes our board of directors to issue up to five million shares of blank check preferred stock. As a result, without further stockholder approval, the board of directors has the authority to attach special rights, including voting and

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dividend rights, to this preferred stock. With these rights, preferred stockholders could make it more difficult for a third party to acquire us. In addition, our amended and restated certificate of incorporation provides for a staggered board of directors, whereby directors serve for three year terms, with one third of the directors coming up for reelection each year. A staggered board will make it more difficult for a third party to obtain control of our board of directors through a proxy contest, which may be a necessary step in an acquisition of us that is not favored by our board of directors.

We are also subject to the anti-takeover provisions of the Delaware General Corporation Law. Under these provisions, if anyone becomes an interested stockholder, we may not enter into a business combination with that person for three years without special approval, which could discourage a third party from making a takeover offer and could delay or prevent a change in control of us. An interested stockholder means, generally, someone owning 15% or more of our outstanding voting stock or an affiliate of ours that owned 15% or more of our outstanding voting stock during the past three years, subject to certain exceptions as described in the Delaware General Corporation Law.

In addition, we have adopted a stockholder rights plan. Under the stockholder rights plan if any person becomes the beneficial owner of 15% or more of the outstanding shares of stock, subject to a number of exceptions set forth in the plan, all of our stockholders other than the acquiring person will receive a right to purchase shares of our stock at a price of \$136.00 per share. Our stockholder rights plan could discourage a takeover attempt and make an unsolicited takeover of our company more difficult. As a result, without the approval of our board of directors, you may not have the opportunity to sell your shares to a potential acquirer of us at a premium over prevailing market prices. This could reduce the market price of our stock.

**\* We may elect to not declare cash dividends on our stock, may elect to only pay dividends on an infrequent or irregular basis, or we may elect to not make any additional stock repurchases, and any return on your investment may be limited to the value of our stock. However, the payment of any future dividends or the repurchase of our stock might limit our ability to pursue other growth opportunities.**

Our board of directors may from time to time declare, and we may pay, dividends on our outstanding shares in the manner and upon the terms and conditions provided by law. However, we may elect to retain all future earnings for the operation and expansion of our business, rather than paying cash dividends on our stock. Any payment of cash dividends on our stock will be at the discretion of our board of directors and will depend upon our results of operations, earnings, capital requirements, financial condition, business prospects, contractual restrictions and other factors deemed relevant by our board of directors. In the event our board of directors declares any dividends, there is no assurance with respect to the amount, timing or frequency of any such dividends.

We previously implemented a stock repurchase program, which terminated pursuant to its terms in April 2012. In the event our board of directors determines to authorize one or more stock repurchase programs in the future, any repurchase of our common stock would be at the discretion of the committee appointed by the board of directors, and would depend on several factors including, but not limited to, results of operations, capital requirements, financial conditions and the market price of our common stock. Therefore, there would be no assurance with respect to the amount, price or timing of any such repurchases. We may elect to retain all future earnings for the operation and expansion of our business, rather than repurchasing additional outstanding shares. In the event we pay dividends, or make any stock repurchases in the future, our ability to finance any material expansion of our business, including through acquisitions, investments or increased capital spending, or to fund our operations, may be limited. In addition, any repurchases we may make in the future may not prove to be at optimal prices. In the event our board of directors determines to authorize one or more stock repurchase programs in the future, our board of directors could modify or amend our stock repurchase programs at its discretion without stockholder approval.

### **Item 6. Exhibits**

The exhibits listed in the Exhibit Index immediately preceding the exhibits are filed as part of this Quarterly Report on Form 10-Q and such Exhibit Index is incorporated herein by reference.

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**SIGNATURES**

Pursuant to the requirements 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.

**MASIMO CORPORATION**

Date: November 1, 2012

By: /s/ Joe Kiani

Joe Kiani  
Chief Executive Officer and Chairman

Date: November 1, 2012

By: /s/ Mark P. de Raad

Mark P. de Raad  
Executive Vice President and Chief Financial Officer

**Table of Contents****EXHIBIT INDEX****Exhibit**

| <b>Number</b> | <b>Description of Document</b>   |
|---------------|--|
| 3.1           | (1) Amended and Restated Certificate of Incorporation (Exhibit 3.2)  |
| 3.2           | (2) Certificate of Designation of Series A Junior Participating Preferred Stock (Exhibit 3.1)  |
| 3.3           | (3) Amended and Restated Bylaws adopted on October 20, 2011 (Exhibit 3.2)  |
| 4.1           | (1) Form of Common Stock Certificate (Exhibit 4.1)   |
| 4.2           | (1) Fifth Amended and Restated Registration Rights Agreement made and entered into as of September 14, 1999 between the Registrant and certain of its stockholders (Exhibit 4.2) |
| 4.3           | (2) Rights Agreement, dated November 9, 2007, between the Company and Computershare Trust Company, N.A., as Rights Agent (Exhibit 4.1)   |
| 4.4#          | (4) Masimo Retirement Savings Plan. (Exhibit 4.7)  |
| 12.1          | Statement Regarding the Computation of Ratio of Earnings to Fixed Charges  |
| 31.1          | Certification of Joe Kiani, Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as amended   |
| 31.2          | Certification of Mark P. de Raad, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as amended   |
| 32.1          | Certification of Joe Kiani, Chief Executive Officer, and Mark P. de Raad, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as amended         |
| 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 report are the following formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets as of September 29, 2012 and December 31, 2011, (ii) Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 29, 2012 and October 1, 2011, (iii) Condensed Consolidated Statements of Cash Flows for the nine months ended September 29, 2012 and October 1, 2011 and (iv) Notes to Condensed Consolidated Financial Statements.

- (1) Incorporated by reference to the exhibits to the Company's Registration Statement on Form S-1 (No. 333-142171) originally filed on April 17, 2007. The number given in parentheses indicates the corresponding exhibit number in such Form S-1, as amended.
  - (2) Incorporated by reference to the exhibits to the Company's Current Report on Form 8-K filed on November 9, 2007. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.
  - (3) Incorporated by reference to the exhibit to the Company's Current Report on Form 8-K filed on October 26, 2011. The number given in parentheses indicates the corresponding exhibit number in such Form 8-K.
  - (4) Incorporated by reference to the exhibit to the Company's Registration Statement on Form S-8 filed on February 11, 2008. The number given in parentheses indicates the corresponding exhibit number in such Form S-8.
- # Indicates management or compensatory plan.