VARIAN MEDICAL SYSTEMS INC
Form 10-Q
February 10, 2009
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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

# FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended January 2, 2009

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____

Commission File Number 1-7598

# VARIAN MEDICAL SYSTEMS, INC.

**(Exact name of registrant as specified in its charter)**

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

**(650) 493-4000**

**(Registrant s telephone number, including area code)**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 124,391,480 shares of common stock, par value $1 per share, outstanding as of January 30, 2009.

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**VARIAN MEDICAL SYSTEMS, INC.**

**FORM 10-Q for the Quarter Ended January 2, 2009**

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**PART I**

**FINANCIAL INFORMATION**

**Item 1. Financial Statements**

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

**CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS**

**(Unaudited)**

| (In thousands, except per share amounts) | Three Months Ended January 2, 2009 | Three Months Ended December 28, 2007 |
|---|---|---|
| **Revenues:** | | |
| Product | $ 402,141 | $ 364,336 |
| Service contracts and other | 106,528 | 86,877 |
| Total revenues | 508,669 | 451,213 |
| **Cost of revenues:** | | |
| Product | 233,280 | 214,560 |
| Service contracts and other | 56,432 | 45,548 |
| Total cost of revenues | 289,712 | 260,108 |
| **Gross margin** | 218,957 | 191,105 |
| **Operating expenses:** | | |
| Research and development | 36,978 | 28,944 |
| Selling, general and administrative | 83,233 | 75,073 |
| Total operating expenses | 120,211 | 104,017 |
| **Operating earnings** | 98,746 | 87,088 |
| Interest income | 2,262 | 2,810 |
| Interest expense | (953) | (1,296) |
| **Earnings from continuing operations before taxes** | 100,055 | 88,602 |
| Taxes on earnings | 30,476 | 30,371 |
| **Earnings from continuing operations** | 69,579 | 58,231 |
| **Loss from discontinued operations, net of taxes** | (782) | (2,752) |
| **Net Earnings** | $ 68,797 | $ 55,479 |
| Net earnings (loss) per share - basic: | | |
| Continuing operations | $ 0.56 | $ 0.47 |
| Discontinued operations | | (0.03) |
| Net earnings per share | $ 0.56 | $ 0.44 |

| | | |
|---|---|---|
| Net earnings (loss) per share - diluted: | | |
| Continuing operations | $ 0.56 | $ 0.46 |
| Discontinued operations | (0.01) | (0.03) |
| Net earnings per share | $ 0.55 | $ 0.43 |
| Shares used in the calculation of net earnings per share: | | |
| Weighted average shares outstanding - Basic | 123,818 | 124,809 |
| Weighted average shares outstanding - Diluted | 125,167 | 127,793 |

*See accompanying notes to the consolidated financial statements.*

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

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(Unaudited)**

| (In thousands, except par values) | January 2, 2009 | September 26, 2008 [1] |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 422,871 | $ 397,306 |
| Accounts receivable, net of allowance for doubtful accounts of $3,362 at January 2, 2009 and $3,110 at September 26, 2008 | 467,415 | 486,310 |
| Inventories | 327,265 | 282,980 |
| Prepaid expenses and other current assets | 55,451 | 78,018 |
| Deferred tax assets | 130,940 | 130,988 |
| Current assets held for sale | 18,603 | 18,799 |
| Total current assets | 1,422,545 | 1,394,401 |
| Property, plant and equipment, net | 253,072 | 218,183 |
| Goodwill | 206,261 | 209,146 |
| Other assets | 152,572 | 150,694 |
| Long-term assets held for sale | 3,552 | 3,088 |
| **Total assets** | $ 2,038,002 | $ 1,975,512 |
| **Liabilities and Stockholders Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 89,726 | $ 105,281 |
| Accrued expenses | 234,850 | 252,915 |
| Product warranty | 49,011 | 51,141 |
| Deferred revenues | 158,168 | 141,368 |
| Advance payments from customers | 224,552 | 201,783 |
| Short-term borrowings | 25,000 | |
| Current maturities of long-term debt | 7,992 | 7,987 |
| Current liabilities held for sale | 21,035 | 21,202 |
| Total current liabilities | 810,334 | 781,677 |
| Long-term debt | 32,337 | 32,399 |
| Other long-term liabilities | 153,065 | 134,251 |
| Total liabilities | 995,736 | 948,327 |
| Commitments and contingencies (Note 9) | | |
| Stockholders equity: | | |
| Preferred stock of $1 par value: 1,000 shares authorized; none issued and outstanding | | |
| Common stock of $1 par value: 189,000 shares authorized; 124,313 and 125,590 shares issued and outstanding at January 2, 2009 and at September 26, 2008, respectively | 124,313 | 125,590 |
| Capital in excess of par value | 468,615 | 468,384 |
| Retained earnings | 467,578 | 451,439 |
| Accumulated other comprehensive loss | (18,240) | (18,228) |
| Total stockholders equity | 1,042,266 | 1,027,185 |

| | | |
|---|---|---|
| **Total liabilities and stockholders equity** | $ 2,038,002 | $ 1,975,512 |

(1) The condensed consolidated balance sheet as of September 26, 2008 was derived from audited financial statements as of that date, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

*See accompanying notes to the consolidated financial statements.*

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

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Unaudited)**

| (In thousands) | Three Months Ended January 2, 2009 | December 28, 2007 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net earnings | $ 68,797 | $ 55,479 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Tax benefits from exercises of share-based payment awards | 2,956 | 11,872 |
| Excess tax benefits from share-based compensation | (2,996) | (10,803) |
| Share-based compensation expense | 10,706 | 9,410 |
| Depreciation | 8,586 | 7,448 |
| Provision for doubtful accounts receivable | 423 | (42) |
| Amortization of intangible assets | 931 | 1,198 |
| Deferred taxes | (1,944) | (1,077) |
| Net change in fair value of derivatives and underlying commitments | 346 | (2,113) |
| Loss on equity investment in affiliate | 7 | 984 |
| Other | (791) | (667) |
| Changes in assets and liabilities: | | |
| Accounts receivable | 10,926 | 74,446 |
| Inventories | (44,958) | (24,671) |
| Prepaid expenses and other current assets | (3,626) | (9,843) |
| Accounts payable | (13,360) | (319) |
| Accrued expenses | 14,434 | (12,111) |
| Deferred revenues | 16,800 | 23,084 |
| Product warranty | (1,725) | 1,715 |
| Advance payments from customers | 22,894 | (7,360) |
| Other long-term liabilities | (3,844) | 4,068 |
| Net cash provided by operating activities | 84,562 | 120,698 |
| **Cash flows from investing activities:** | | |
| Purchases of property, plant and equipment | (18,467) | (16,592) |
| (Increase) Decrease in cash surrender value of life insurance | (1,391) | 399 |
| Notes repayment from affiliate and other | 169 | 317 |
| Proceeds from disposal of property, plant and equipment | 26 | 46 |
| Other, net | (2,454) | (1,775) |
| Net cash used in investing activities | (22,117) | (17,605) |
| **Cash flows from financing activities:** | | |
| Repurchases of common stock | (71,541) | (41,196) |
| Proceeds from issuance of common stock to employees | 4,491 | 24,350 |
| Excess tax benefits from share-based compensation | 2,996 | 10,803 |
| Net borrowings (repayments) under line of credit agreement | 25,000 | (23,000) |
| Employees taxes withheld and paid for restricted stock | (285) | (310) |
| Repayments on bank borrowings | (57) | (53) |
| Other | (64) | |
| Net cash used in financing activities | (39,460) | (29,406) |

| | | |
|---|---|---|
| Effects of exchange rate changes on cash and cash equivalents | 2,580 | (2,851) |
| Net increase in cash and cash equivalents | 25,565 | 70,836 |
| Cash and cash equivalents at beginning of period | 397,306 | 263,246 |
| Cash and cash equivalents at end of period | $ 422,871 | $ 334,082 |

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

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

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

***Description of Business***

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

***Fiscal Year***

The fiscal years of the Company as reported are the 52- or 53- week periods ending on the Friday nearest September 30. Fiscal year 2009 is the 53-week period ending October 2, 2009, and fiscal year 2008 was the 52-week period that ended on September 26, 2008. The fiscal quarter ended January 2, 2009 was a 14-week period and the fiscal quarter ended December 28, 2007 was a 13-week period.

***Principles of Consolidation***

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

***Basis of Presentation***

The condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States ( GAAP ) have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements and the accompanying notes are unaudited and should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended September 26, 2008 (the 2008 Annual Report ). In the opinion of management, the condensed consolidated financial statements herein include adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Company s financial position as of January 2, 2009 and September 26, 2008, results of operations for the three months ended January 2, 2009 and December 28, 2007, and cash flows for the three months ended January 2, 2009 and December 28, 2007. The results of operations for the three months ended January 2, 2009 are not necessarily indicative of the operating results to be expected for the full fiscal year or any future period.

***Use of Estimates***

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

***Revenue Recognition***

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

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

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

**(Unaudited)**

**Hardware Products**

Except as described below under Other, the Company recognizes revenues for hardware products in accordance with Staff Accounting Bulletin ( SAB ) No. 104, *Revenue Recognition* ( SAB 104 ), when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable and collectibility is reasonably assured. For an arrangement with multiple deliverables, the Company recognizes product revenues in accordance with Emerging Issues Task Force ( EITF ) No. 00-21, *Revenue Arrangements with Multiple Deliverables* ( EITF 00-21 ) and EITF No. 03-05, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*, with revenues allocated among the different elements. Except for government tenders, group purchases and orders with letters of credit, the Company typically requires its customers to provide a down payment prior to transfer of risk of loss of ordered products or prior to performance under service contracts. These down payments are recorded as Advance payments from customers in the Consolidated Balance Sheets.

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

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

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

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

**Software Products**

Except as described below under Other, the Company recognizes revenues for software products in accordance with Statement of Position No. 97-2, *Software Revenue Recognition* ( SOP 97-2 ), as amended by SOP No. 98-9, *Software Revenue Recognition with Respect to Certain Agreements*. The Company recognizes license revenues when all of the following criteria are met: persuasive evidence of an arrangement exists, the vendor s fee is fixed or determinable, collection of the related receivable is probable, delivery of the product has occurred and the Company has received from the customer an acceptance form acknowledging installation and substantial conformance with the Company s specifications (as set forth in the user manual) for such product, or upon verification of installation when customer acceptance is not required to be received, or

upon the expiration of an acceptance period, provided that all other criteria for revenue recognition under SOP

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

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

**(Unaudited)**

97-2 have been met. Revenues earned on software arrangements involving multiple elements are allocated to each element based on vendor-specific objective evidence of the fair value ( VSOE ), which is based on the price charged when the same element is sold separately. In instances when evidence of VSOE of all undelivered elements exists, but evidence does not exist for one or more delivered elements, revenues are recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. Revenue allocated to maintenance and support is recognized ratably over the maintenance term (typically one year).

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

The Company does not have installation obligations for certain brachytherapy and SIP software products. For software products that do not include installation obligations, the Company recognizes revenues upon the transfer of risk of loss, which is either at the time of shipment or delivery, depending upon the shipping terms of the contract, provided that all other criteria under SOP 97-2 are met.

**Service Contracts and Other**

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

Revenues related to certain proton therapy commissioning service contracts and highly customized image detection systems are recognized under the percentage-of-completion method or the completed-contract method in accordance with SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Product Type Contracts*. Revenues recognized under the percentage-of-completion method are primarily based on contract costs incurred to date compared with total estimated contract costs. Estimated losses on contracts are charged to cost of sales in the period when the loss is identified.

Deferred revenue as of the end of each period represents the amount of unrecognized hardware and software revenues that was invoiced.

***Recent Accounting Pronouncements***

In September 2006, the Financial Accounting Standards Board ( FASB ), issued Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in conformity with GAAP, and expands disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position ( FSP ), No. FAS 157-1 ( FSP No. 157-1 ), and FSP No. FAS 157-2 ( FSP No. 157-2 ). FSP No. 157-1 amends SFAS 157 to exclude from its scope SFAS No. 13, *Accounting for Leases* ( SFAS 13 ), and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under SFAS 13. FSP No. 157-2 delays the effective date of SFAS 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis, to the Company s first quarter of fiscal year 2010. In October 2008, the FASB issued FSP No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* ( FSP 157-3 ). FSP 157-3 clarifies the application of SFAS 157 in a market that is not active, and addresses application issues such as the use of internal assumptions when relevant observable data does not exist, the use of observable market information when the market is not active, and the use of market quotes when assessing the relevance of observable and unobservable data. FSP 157-3 is effective for all periods presented in accordance with SFAS 157. The measurement and disclosure requirements of SFAS 157 related to financial

assets and financial liabilities were effective for the Company in the first quarter of fiscal year 2009.

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

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

**(Unaudited)**

The adoption of SFAS 157 for financial assets and financial liabilities did not have a material impact on the Company s consolidated financial position, results of operations and cash flows. The Company is currently assessing the impact that SFAS 157 will have on its consolidated financial position, results of operations or cash flows when SFAS 157 is applied to nonfinancial assets and nonfinancial liabilities beginning in the first quarter of fiscal 2010.

In September 2006, the FASB issued SFAS No. 158, *Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R)* ( SFAS 158 ). SFAS 158 requires the Company to (a) recognize a plan s funded status in its statement of financial position, (b) measure a plan s assets and the obligations that determine its funded status as of the end of its fiscal year and (c) recognize changes in the funded status of a defined benefit plan in the year in which the changes occur through other comprehensive income. The Company adopted the requirement to recognize the funded status of a defined benefit plan and the disclosure requirements in the fourth quarter of fiscal year 2007. Please refer to Note 10 Retirement Plans in the 2008 Annual Report for a discussion of the effects of adopting the recognition provisions and disclosure requirements of SFAS 158. The adoption of the measurement date provisions of SFAS 158 did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities -Including an Amendment of FASB Statement No. 115* ( SFAS 159 ). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The adoption of SFAS 159 in the first quarter of fiscal year 2009 did not have a material impact on the Company s consolidated financial position, results of operations or cash flows. The Company has currently chosen not to elect the fair value option for any items that are not already required to be measured at fair value in accordance with GAAP.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS 141(R) ). SFAS 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141(R) also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141(R) is effective for the Company in the first quarter of fiscal year 2010. The impact of the adoption of SFAS 141(R) will depend on the nature and extent of business combinations occurring on or after the beginning of fiscal year 2010.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51* ( SFAS 160 ). SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent s, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent s ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective for the Company in the first quarter of fiscal year 2010. The Company is currently assessing the potential impact, if any, SFAS 160 may have on its consolidated financial position, results of operations and cash flows.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* ( SFAS 161 ), which is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity s financial position, financial performance and cash flows. SFAS 161 is effective for the Company in the second quarter of fiscal year 2009. The Company does not believe the adoption of SFAS 161 will have a material impact on its consolidated financial position, results of operations and cash flows.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS 162 ), which identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP (the GAAP hierarchy). SFAS 162 will become effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. The adoption of SFAS 162 did not have a material effect on the Company s consolidated financial position, results of operations or cash flows.

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

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

**(Unaudited)**

In November 2008, the FASB ratified EITF Issue No. 08-6, *Equity Method Investment Accounting Considerations* ( EITF 08-6 ). EITF 08-6 clarifies the accounting for certain transactions and impairment considerations involving equity method investments. EITF 08-6 is effective for the Company in the first quarter of fiscal year 2010, with early adoption prohibited. The Company is currently assessing the potential impact, if any, EITF 08-6 may have on its consolidated financial position, results of operations and cash flows.

In November 2008, the FASB ratified EITF Issue No. 08-7, *Accounting for Defensive Intangible Assets* ( EITF 08-7 ). EITF 08-7 clarifies the accounting for certain separately identifiable intangible assets which an acquirer does not intend to actively use but intends to hold to prevent its competitors from obtaining access to them. EITF 08-7 requires an acquirer in a business combination to account for a defensive intangible asset as a separate unit of accounting which should be amortized to expense over the period the asset diminishes in value. EITF 08-7 is effective for the Company in the first quarter of fiscal year 2010, with early adoption prohibited. The impact of the adoption of EITF 08-7 will depend on the nature and extent of defensive intangible assets acquired on or after the beginning of fiscal year 2010.

In December 2008, the FASB issued FSP No. FAS 132(R)-1, *Employers Disclosures about Postretirement Benefit Plan Assets* ( FSP No. 132(R)-1 ). FSP No. 132(R)-1, which amends SFAS 132(R) *Employers Disclosures about Pensions and Other Postretirement Benefits*, provides guidance on an employer s disclosure about plan assets of a defined benefit pension or other postretirement plan and requires employers to disclose information about fair value measurements of plan assets similar to the disclosure about fair value measurements requirement under SFAS 157. FSP No. 132(R)-1 will be effective for the Company in fiscal year 2010.

***Reclassifications***

Certain financial statement items have been reclassified to conform to the current fiscal year s format. As discussed in Note 16 Discontinued Operations and Assets Held for Sale , the Company classified the assets and liabilities of the scientific research instruments business of ACCEL Instruments GmbH ( ACCEL ) ( Research Instruments ) as held for sale in the Condensed Consolidated Balance Sheets and presented its operating results as a discontinued operation in the Condensed Consolidated Statement of Earnings for all periods presented. Because amounts related to Research Instruments in the Condensed Consolidated Statements of Cash Flows were not material for any period presented, the Company has not segregated them from continuing operations. Unless noted otherwise, discussion in these notes pertains to the Company s continuing operations. These reclassifications had no impact on previously reported total net earnings.

**2. BALANCE SHEET COMPONENTS:**

The components of inventories are as follows:

| (In millions) | January 2, 2009 | September 26, 2008 |
|---|---|---|
| Raw materials and parts | $ 170.9 | $ 156.8 |
| Work-in-progress | 45.3 | 36.6 |
| Finished goods | 111.1 | 89.6 |
| Total inventories | $ 327.3 | $ 283.0 |

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

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

**(Unaudited)**

| (In millions) | January 2, 2009 | September 26, 2008 |
|---|---|---|
| ***Property, plant and equipment:*** | | |
| Land, land leaseholds and land improvements | $ 37.5 | $ 11.4 |
| Buildings and leasedhold improvements | 173.1 | 167.6 |
| Machinery and equipment | 230.9 | 226.3 |
| Construction in progress[1] | 53.4 | 46.5 |
| Assets subject to lease | 0.8 | 0.8 |
| | 495.7 | 452.6 |
| Accumulated depreciation and amortization | (242.6) | (234.4) |
| Property, plant and equipment, net | $ 253.1 | $ 218.2 |

(1) Includes capitalized costs of $30.4 million as of January 2, 2009 and $28.8 million as of September 26, 2008 for the implementation of the Company s enterprise resource planning system used for its worldwide operations, which was placed in service in the second quarter of fiscal year 2009.

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

| (In millions) | January 2, 2009 | September 26, 2008 |
|---|---|---|
| Long-term income taxes payable | $ 85.5 | $ 89.5 |
| Other | 67.6 | 44.8 |
| Total other long-term liabilities | $ 153.1 | $ 134.3 |

The Other category of other long-term liabilities primarily consisted of accruals for environmental costs, accrued pension and post-retirement benefits, deferred income tax liabilities and obligations for acquired building and land leaseholds as of January 2, 2009. As of September 26, 2008, the Other category of other long-term liabilities primarily consisted of accruals for environmental costs, accrued pension and post-retirement benefits and deferred income tax liabilities.

**3. FAIR VALUE**

Effective September 27, 2008, the Company adopted SFAS 157, which defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. SFAS 157 establishes a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

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

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

by observable market data.

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

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

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

**(Unaudited)**

The Company s financial assets and liabilities are valued using Level 1 and Level 2 inputs. Level 1 instrument valuations are obtained from quotes for transactions in active exchange markets involving identical assets. Level 2 instruments include valuations obtained from quoted prices for identical assets in markets that are not active. In addition, the Company has elected to use the income approach to value its derivative instruments using standard valuation techniques and Level 2 inputs, such as currency spot rates, forward points and credit default swap spreads. The Company s derivative instruments are short-term in nature, typically one month to twelve months in duration. As of January 2, 2009, the Company did not have any financial assets or liabilities without observable market values that would require a high level of judgment to determine fair value (Level 3 instruments).

The Company s adoption of SFAS 157 did not have a material impact on its consolidated financial statements. The Company has segregated all financial assets and liabilities that are measured at fair value on a recurring basis (at least annually) into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value at the measurement date in the table below. FSP No. 157-2 delayed the effective date for all nonfinancial assets and liabilities until the first quarter of fiscal year 2010, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis.

Effective September 27, 2008, the Company adopted SFAS 159, which provides entities the option to measure many financial instruments and certain other items at fair value. The Company has currently chosen not to elect the fair value option for any items that are not already required to be measured at fair value in accordance with GAAP.

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

The following tables present the Company s financial assets and liabilities as of January 2, 2009 that are measured at fair value on a recurring basis:

| | Fair Value Measurement Using | | | |
|---|---|---|---|---|
| **Type of Instruments (In millions)** | **Quoted Prices in Active Markets for Identical Instruments (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** | **Total Balance** |
| **Assets:** | | | | |
| Money market funds | $ 11.8 | $ | $ | $ 11.8 |
| Derivative assets | | 2.1 | | 2.1 |
| Total assets measured at fair value | $ 11.8 | $ 2.1 | $ | $ 13.9 |
| **Liabilities:** | | | | |
| Derivative liabilities | $ | $ (0.4) | $ | $ (0.4) |
| Total liabilities measured at fair value | $ | $ (0.4) | $ | $ (0.4) |

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

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

**(Unaudited)**

| Line Item in Condensed Consolidated Balance Sheet (In millions) | Fair Value Measurement Using: Quoted Prices in Active Markets for Identical Instruments (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Balance |
|---|---|---|---|---|
| **Assets:** | | | | |
| Cash and cash equivalents | $ 10.8 | $ | $ | $ 10.8 |
| Prepaid expenses | | 2.1 | | 2.1 |
| Other assets | 1.0 | | | 1.0 |
| Total assets measured at fair value | $ 11.8 | $ 2.1 | $ | $ 13.9 |
| **Liabilities:** | | | | |
| Accrued liabilities | $ | $ (0.4) | $ | $ (0.4) |
| Total liabilities measured at fair value | $ | $ (0.4) | $ | $ (0.4) |

**4. GOODWILL AND INTANGIBLE ASSETS**

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

| (In millions) | January 2, 2009 | September 26, 2008 |
|---|---|---|
| ***Intangible Assets:*** | | |
| Acquired existing technology | $ 19.6 | $ 19.7 |
| Patents, licenses and other | 14.5 | 14.5 |
| Customer contracts and supplier relationships | 10.4 | 10.5 |
| Accumulated amortization | (34.5) | (33.6) |
| Net carrying amount | $ 10.0 | $ 11.1 |

Amortization expense for intangible assets required to be amortized under SFAS No.142, *Goodwill and Other Intangible Assets* ( SFAS 142 ), was $0.9 million and $1.1 million for the three months ended January 2, 2009 and December 28, 2007, respectively. The Company estimates amortization expense on a straight-line basis for the remaining nine months of fiscal year 2009, fiscal years 2010 through 2013 and thereafter, to be as follows (in millions):$2.6, $2.9, $2.2, $1.3, $0.9 and $0.1.

The following table reflects the allocation of goodwill:

**(In millions)**

| | January 2, 2009 | September 26, 2008 |
|---|---|---|
| Oncology Systems | $ 125.5 | $ 125.4 |
| X-ray Products | 2.7 | 2.7 |
| Other | 78.1 | 81.0 |
| Total | $ 206.3 | $ 209.1 |

The change in goodwill balance in the Other category reflects the impact of foreign currency translation adjustments.

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

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

**(Unaudited)**

**5. RELATED PARTY TRANSACTIONS**

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

In September 2004, VMS acquired another member s 20% ownership interest in dpiX Holding for $1 million. As a result, VMS has the right to appoint two managers of the five person board of managers and its ownership interest in dpiX Holding increased to 40% with the remaining 60% being held by the other original member. When VMS acquired this additional 20% ownership interest, the capital account of the selling member was nearly zero because it was the first in the consortium to be allocated losses. As a result, when dpiX Holding recorded net profits after VMS acquired the additional 20% ownership interest, VMS was the first to be allocated net profits to recover previously allocated losses. VMS recorded loss on the equity investment in dpiX Holding of $7,000 in the three months ended January 2, 2009 and a loss of $1 million in the three months ended December 28, 2007. Incomes and losses on the equity investment in dpiX Holding are included in Selling, general and administrative expenses in the Condensed Consolidated Statements of Earnings.

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

In December 2004, VMS agreed to loan $2 million to dpiX in four separate installments, with the loan bearing interest at prime plus 1% per annum. The principal balance is due and payable to VMS in twelve equal quarterly installments that began in October 2006; interest is payable in full according to a quarterly schedule, which began in April 2005; and the entire principal balance, together with accrued and unpaid interest thereon and all other related amounts payable thereunder, is due and payable on July 10, 2009. The note receivable from dpiX of $0.5 million and $0.7 million at January 2, 2009 and September 26, 2008, respectively, was included in Prepaid Expense in the Condensed Consolidated Balance Sheets.

In February 2008, VMS agreed to loan an additional $1.6 million to dpiX, with the loan bearing interest at prime plus 1% per annum. The principal balance is due and payable to VMS in twelve equal quarterly installments beginning in January 2010; interest is payable in full according to a quarterly schedule which began in April 2008; and the entire principal balance, together with accrued and unpaid interest thereon and all other related amounts payable hereunder, is due and payable on October 10, 2012. The additional note receivable from dpiX of $1.6 million at both January 2, 2009 and September 26, 2008 was included in Other Assets in the Condensed Consolidated Balance Sheets.

In March 2006, VMS and the other member of dpiX Holding agreed to invest an aggregate $92 million in dpiX Holding, with each member s contribution based on its percentage ownership interest in dpiX Holding, for dpiX to acquire and construct a manufacturing facility in Colorado to increase its production capacity. As of January 2, 2009 and September 26, 2008, VMS s contribution of $36.8 million to dpiX Holding for the Colorado manufacturing facility was included in Other assets in the Condensed Consolidated Balance Sheets.

During the three months ended January 2, 2009 and December 28, 2007, the Company purchased glass transistor arrays from dpiX totaling approximately $7.8 million and $5.5 million, respectively. These purchases of flat panels are included as a component of Inventory in the Condensed Consolidated Balance Sheets and Cost of revenues - product in the Condensed Consolidated Statements of Earnings for these

periods.

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

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

**(Unaudited)**

**6. PRODUCT WARRANTY**

The following table reflects the changes in the Company s accrued product warranty during the three months ended January 2, 2009 and December 28, 2007:

| | Three Months Ended | |
|---|---|---|
| **(In millions)** | **January 2, 2009** | **December 28, 2007** |
| Accrued product warranty, at beginning of period | $ 51.1 | $ 51.3 |
| Charged to cost of revenues | 11.2 | 12.5 |
| Actual product warranty expenditures | (13.3) | (10.8) |
| Accrued product warranty, at end of period | $ 49.0 | $ 53.0 |

**7. CREDIT FACILITY**

In July 2007, the Company entered into a credit agreement with Bank of America, N.A. ( BofA ) providing for an unsecured revolving credit facility that enabled the Company to borrow and have outstanding at any given time a maximum of $100 million (the BofA Credit Facility ). On November 10, 2008, the Company amended and restated the BofA Credit Facility (the Amended BofA Credit Facility ) to increase the line of credit to $150 million and collateralize a portion of the credit facility with a pledge of stock of certain of the Company s present and future subsidiaries that are deemed to be material subsidiaries under the terms of the Amended BofA Credit Facility. As of January 2, 2009, the Company has pledged to BofA 65% of the voting shares that it holds in Varian Medical Systems Nederland B.V., a wholly-owned subsidiary. The Amended BofA Credit Facility may be used for working capital, capital expenditures, permitted acquisitions and other lawful corporate purposes. The Amended BofA Credit Facility will expire, if not extended by mutual agreement of the Company and BofA, on November 10, 2011. Borrowings under the Amended BofA Credit Facility accrue interest either (i) based on the London Inter Bank Offered Rate ( LIBOR ) plus a margin of 1.25% to 1.50% based on a leverage ratio involving funded indebtedness and earnings before interest, taxes, depreciation and amortization ( EBITDA ), or (ii) based upon a base rate of either the federal funds rate plus 0.5% or BofA s announced prime rate, whichever is greater, minus a margin of 0.5% to 0% based on a leverage ratio involving funded indebtedness and EBITDA, depending upon the Company s instructions to BofA. The Company may select borrowing periods of one, two, three or six months for advances based on the LIBOR rate. Interest rates on advances based on the base rate are adjustable daily.

At January 2, 2009, $25 million was outstanding under the Amended BofA Credit Facility with a weighted average interest rate of 2.89%. There was no outstanding balance under the BofA Credit Facility as of September 26, 2008. The Amended BofA Credit Facility also provided $25 million to support letters of credit issued on behalf of the Company, of which none were outstanding as of January 2, 2009.

The Amended BofA Credit Facility contains customary affirmative and negative covenants for facilities of this type. The Company has also agreed to maintain certain financial covenants relating to (i) leverage ratios involving funded indebtedness and EBITDA, (ii) liquidity and (iii) consolidated assets. As of January 2, 2009, the Company was in compliance with all covenants.

**8. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

The Company accounts for derivative instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended by SFAS No. 149, *Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities* ( SFAS 133 ). The Company has many transactions denominated in foreign currencies and addresses certain of those financial exposures through a program of risk management that includes the use of derivative financial instruments. The Company sells products throughout the world, often in the local

currency of the customer s country, and typically hedges certain of these larger foreign currency transactions when they are not in the subsidiaries functional currency. These foreign currency sales transactions are hedged using forward exchange contracts. The Company may use other derivative instruments in the future. The Company enters into foreign currency forward exchange contracts primarily to reduce the effects of fluctuating foreign currency exchange rates. The Company does not enter into forward exchange contracts for speculative or trading purposes. The forward exchange contracts range from one to twelve months in maturity. As of January 2, 2009, the Company did not have any forward exchange contracts with an original maturity greater than twelve months.

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

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

**(Unaudited)**

*(a) Cash Flow Hedging Activities*

The hedges of foreign currency denominated forecasted revenues are accounted for in accordance with SFAS 133, pursuant to which the Company has designated its hedges of anticipated foreign currency revenues as cash flow hedges. During the first quarter of fiscal year 2009, there were no material gains or losses due to hedge ineffectiveness of cash flow hedges and the Company did not discontinue any cash flow hedges that had a material impact on the Company s results of operations. The Company did not have any cash flow hedges in the first quarter of fiscal years 2008. As of January 2, 2009, net unrealized gain on derivative instruments of $1.8 million, before tax, is included in Accumulated other comprehensive loss, and is expected to be reclassified to net earnings over the next twelve months.

*(b) Fair Value Hedging Activities*

During the first quarter of fiscal years 2009 and 2008, there were no material gains or losses due to hedge ineffectiveness of fair value hedges and there were no material gains or losses recognized when hedged firm commitments no longer qualified as fair value hedges. At January 2, 2009, the Company had no outstanding foreign exchange forward contracts designated as fair value hedges.

*(c) Balance Sheet Hedging Activities*

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

Changes in the values of these hedging instruments are offset by changes in the values of foreign currency denominated assets and liabilities. Variations from the forecasted foreign currency assets or liabilities, coupled with a significant currency movement, may result in a material gain or loss if the hedges are not effectively offsetting the change in value of the foreign currency asset or liability. Other than foreign exchange hedging activities, the Company has no other freestanding or embedded derivative instruments.

At January 2, 2009, the Company had foreign exchange forward contracts with notional values to sell and purchase $305.1 million and $51.1 million, respectively, in various foreign currencies. At September 26, 2008, the Company had foreign exchange forward contracts with notional values to sell and purchase $280.9 million and $62.7 million, respectively, in various foreign currencies.

**9. COMMITMENTS AND CONTINGENCIES**

***Commitments***

In October 2008, the Company consummated an agreement with Varian, Inc ( VI ), under which VI will surrender its sublease of a building containing approximately 210,000 square feet of floor space and the related leasehold interest for the land; the term of this sublease expires in the year 2056. This building, which is located adjacent to the Company s corporate headquarters in Palo Alto, California, will support the growth of the Company s operations and its longer term objective of co-locating certain of its operations. Pursuant to this agreement, VI agreed to surrender the space in the building to the Company over the period which began in October 2008 and which ends in June 2010 and the Company agreed to pay VI an aggregate of $21 million in cash and assume the obligations of sublessor under a below-market rate sublease to a third party for a portion of the building. As of January 2, 2009, $5 million had been paid to VI pursuant to this agreement and the remaining $16 million will be payable in June 2010 when VI completely surrenders this building to the Company. The amount payable to VI is included in Other long-term liabilities in the Condensed Consolidated Balance Sheet.

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

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

**(Unaudited)**

***Environmental Remediation Liabilities***

The U.S. Environmental Protection Agency ( EPA ) or third parties have named the Company as a potentially responsible party ( PRP ) under the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended ( CERCLA ), at nine sites where the Company, as Varian Associates, Inc., was alleged to have shipped manufacturing waste for recycling or disposal and, as a PRP, the Company may have an obligation to reimburse the EPA or other third parties for cleanup costs at these sites. In addition, the Company is overseeing environmental cleanup projects and, as applicable, reimbursing third parties for cleanup activities under the direction of, or in consultation with, federal, state and/or local agencies at certain current VMS or former Varian Associates, Inc. facilities. Under the terms of the agreement governing the Spin-offs of VI and Varian Semiconductor Equipment Associates, Inc. ( VSEA ), by the Company in 1999, VI and VSEA are each obligated to indemnify the Company for one-third of these environmental cleanup costs (after adjusting for any insurance proceeds realized or tax benefits recognized by the Company). The Company spent $0.2 million and $0.3 million (net of amounts borne by VI and VSEA) during the three months ended January 2, 2009 and December 28, 2007, respectively, on environmental cleanup costs, third-party claim costs, project management costs and legal costs.

Various uncertainties make it difficult to estimate, or determine the likelihood within a range of estimates of, the project management costs, legal costs and costs of certain third-party claims at all of the sites and facilities. In addition, for the nine sites and one of the facilities, various uncertainties make it difficult to assess the likelihood and scope of further cleanup activities or to estimate the future cost of such activities. As of January 2, 2009, the Company nonetheless estimated that the Company s future exposure (net of VI s and VSEA s indemnification obligations) for the cleanup costs for these ten locations, as well as project management costs, legal costs and the costs of certain third party-claims for all locations ranged in the aggregate from $3.2 million to $7.3 million. Management believes that no amount in the range of estimated future costs is more probable of being incurred than any other amount in the range and therefore accrued $3.2 million for these cleanup projects as of January 2, 2009. The amount accrued has not been discounted to present value due to the uncertainties that make it difficult to develop a best estimate of future costs.

As to all other facilities, the Company has gained sufficient knowledge to better estimate the scope and costs of future cleanup activities based upon formal agreements with other parties defining the Company s future liabilities or formal cleanup plans that have either been approved by or completed in accordance with the requirements of the state or federal environmental agency with jurisdiction over the facility. As of January 2, 2009, the Company estimated that the Company s future exposure (net of VI s and VSEA s indemnification obligations) for the cleanup costs at these facilities, and reimbursements of third party s claims for these facilities, ranged in the aggregate from $6.3 million to $37.0 million. The time frames over which these cleanup project costs are estimated vary, ranging from 1 year to 30 years as of January 2, 2009. As to each of these facilities, management determined that a particular amount within the range of estimated costs was a better estimate of the future environmental liability than any other amount within the range, and that the amount and timing of these future costs were reliably determinable. The best estimate within the range was $16.3 million at January 2, 2009. The Company accordingly accrued $11.4 million, which represents its best estimate of the future costs of $16.3 million discounted at 4%, net of inflation. This accrual is in addition to the $3.2 million described in the preceding paragraph.

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

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

The Company evaluates its liability for environmental-related investigation and cleanup costs in light of the liability and financial strength of potentially responsible parties and insurance companies with respect to which the Company believes that it has rights to contribution, indemnity and/or reimbursement (in addition to the obligations of VI and VSEA). Claims for recovery of environmental investigation and cleanup costs already incurred, and to be incurred in the future, have been asserted against various insurance companies and other third parties. The Company receives certain cash payments in the form of settlements and judgments from defendants, its insurers and other third parties from time to time. The Company has also reached an agreement with an insurance company under which that insurance company agreed to pay a portion of the Company s past and future environmental-related expenditures. Accordingly, the Company recorded a receivable of $2.9 million both at January 2, 2009 and September 26, 2008, which was included primarily in Other assets in the Condensed Consolidated Balance Sheets. The Company believes that this receivable is recoverable because it is based on a binding, written settlement agreement with a solvent and financially viable insurance company and the insurance company has in the past paid the claims that the Company has made.

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

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**(Unaudited)**

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

When the Company acquired ACCEL in January 2007, ACCEL was involved in a contract-related lawsuit. Subsequent to the acquisition, the Company settled this lawsuit and agreed to perform certain services under a new contract for a fixed price. From January to September 2007, the Company gathered information related to the expected cost of satisfying its contractual commitments and completed its assessment as of September 28, 2007. As a result, the final purchase price allocation of ACCEL included a loss accrual related to this contingency of 28.3 million. If the actual costs related to the contingency exceed the estimated amount or if the estimated loss increases, the variances will be recognized in the Consolidated Statement of Earnings in the periods these variances arise. As of January 2, 2009, the actual costs incurred had been consistent with the estimated costs for the contract and the balance of the loss accrual related to this contingency was 9.8 million. The Company is currently engaged in arbitration to resolve a dispute under the new contract.

***Other Matters***

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

**10. RETIREMENT PLANS**

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

| | Three Months Ended | |
|---|---|---|
| **(In thousands)** | **January 2, 2009** | **December 28, 2007** |