COMPUTER MOTION INC
Form 10-Q
November 14, 2002

Table of Contents

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2002

Commission File Number 000-22755

COMPUTER MOTION, INC.

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

Delaware	**77-0458805**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

130-B Cremona Drive
Goleta, CA 93117

(Address of principal executive offices)
(805) 968-9600
(Registrant s telephone number, including area code)

Indicate by check /X/ whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve (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 ninety (90) days.

Yes /X/ No / /

As of November 7, 2002 there were 17,456,405 shares of the Registrant s Common Stock outstanding.

TABLE OF CONTENTS

Table of Contents

COMPUTER MOTION, INC.
INDEX TO FORM 10-Q
QUARTER ENDED SEPTEMBER 30, 2002

Table of Contents

COMPUTER MOTION, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts in thousands, except per share amounts)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Revenue	$ 4,534	$ 7,158	$ 15,289	$ 16,877
Cost of revenue	1,997	2,939	6,859	7,261
Gross profit	2,537	4,219	8,430	9,616
Gross profit %	56%	59%	55%	57%
Research & development expense	2,943	2,744	8,454	8,384
Selling, general & administrative expense	5,138	4,390	14,887	13,728
Total operating expense	8,081	7,134	23,341	22,112
Loss from operations	(5,544)	(2,915)	(14,911)	(12,496)
Interest income	8	11	51	87
Interest expense	(12)	(28)	(31)	(78)
Foreign currency translation gain/(loss)	32	1	3	87
Other expense			(8)	(19)
Total other income/(expense)	28	(16)	15	77
Loss before income tax provision	(5,516)	(2,931)	(14,896)	(12,419)
Income tax provision	10	6	22	18
Net loss	(5,526)	(2,937)	(14,918)	(12,437)
Dividend to Series B preferred shareholders		307	4,978	3,001
Net loss available to common shareholders	$ (5,526)	$ (3,244)	$ (19,896)	$ (15,438)
Weighted average common shares outstanding used to compute net loss per share - basic and diluted	17,395	10,367	16,382	10,206
Net loss per share - basic and diluted	$ (0.32)	$ (0.31)	$ (1.21)	$ (1.51)

See accompanying notes to condensed consolidated financial statements

Table of Contents

COMPUTER MOTION, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Amounts in thousands, except par value)

ASSETS	September 30, 2002 (unaudited)	December 31, 2001 (1)
Current assets:		
Cash and cash equivalents	$ 2,151	$ 987
Restricted cash	173	80
Accounts receivable, net of allowance for doubtful accounts and returns of $466 at September 30, 2002; and $1,184 at December 31, 2001	2,510	8,594
Inventories	7,022	5,853
Other current assets	872	811
Total current assets	12,728	16,325
Property and equipment:		
Furniture and fixtures	1,896	2,020
Computer equipment	2,943	2,889
Machinery and equipment	5,911	5,381
Accumulated depreciation	(6,869)	(5,492)
Property and equipment, net	3,881	4,798
Other assets	57	63
Total assets	$ 16,666	$ 21,186
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Note payable to shareholder	$ 1,000	$ 900
Accounts payable	4,855	6,497
Accrued expenses	4,361	4,551
Deferred revenue	2,568	3,628
Total current liabilities	12,784	15,576
Deferred revenue	1,404	1,711
Other liabilities	11	37
Total liabilities	14,199	17,324
Shareholders equity:		
Mandatorily redeemable Series B convertible preferred stock, $.001 par value, authorized 5,000 shares, outstanding at 9/30/02-None; 12/31/01- 8.5 shares		8,674
Common stock, $.001 par value, authorized - 50,000 shares; Outstanding 09/30/02 - 17,420 shares; 12/31/01- 11,439 shares	18	11
Additional paid-in capital	107,309	80,343
Deferred compensation	(287)	(326)
Accumulated deficit	(104,491)	(84,594)
Other comprehensive loss	(82)	(246)
Total shareholders equity	2,467	3,862
Total liabilities & shareholders equity	$ 16,666	$ 21,186

(1) Derived from audited financial statements as of December 31, 2001

See accompanying notes to condensed consolidated financial statements

Table of Contents

COMPUTER MOTION INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended September 30,	
	2002	**2001**
Cash Flows from Operating Activities:		
Net Loss	$(14,918)	$(12,437)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,502	1,243
Provision for doubtful accounts and sales allowances		250
Common stock issued for services	1,395	
Stock options issued for services	631	
Amortization of deferred compensation	39	128
Other	1	(22)
Decrease (Increase) in:		
Accounts receivable	6,084	4,688
Inventories	(1,169)	(2,432)
Other current assets	(61)	(469)
Increase (Decrease) in:		
Accounts payable	(1,642)	821
Accrued expenses	(190)	53
Other liabilities	(26)	
Deferred revenue	(1,367)	790
Net cash used in operating activities	(9,721)	(7,387)
Cash flows from Investing Activities:		
Purchase of property and equipment	(581)	(1,425)
Increase in restricted deposits		(80)
Net cash used in investing activities	(581)	(1,505)
Cash Flows from Financing Activities:		
Repayment of note payable to shareholder	(900)	(3,000)
Proceeds from note payable to shareholder	1,000	900
Proceeds from preferred stock issuance		9,610
Proceeds from common stock issued and warrants exercised, net of repurchases	10,494	2,020
Proceeds from common stock - Societe Generale (Equity Line)	508	
Proceeds from common stock - ESPP plan	61	
Proceeds from exercise of stock options	232	
Comprehensive loss and other	164	13
Net cash provided by financing activities	11,559	9,543
Net increase in cash, cash equivalents and restricted cash	1,257	651
Cash, cash equivalents and restricted cash at beginning of period	1,067	1,551
Cash, cash equivalents and restricted cash at end of period	$ 2,324	$ 2,202

See accompanying notes to condensed consolidated financial statements

Table of Contents

COMPUTER MOTION, INC.
Notes to Condensed Consolidated Financial Statements

Note 1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Computer Motion, Inc. (the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the financial information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included.

The operating results of the interim periods presented are not necessarily indicative of the results expected for the entire fiscal year ending December 31, 2002 or for any other interim period. The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the audited financial statements and notes thereto for the fiscal year ended December 31, 2001 included in the Company s Annual Report on Form 10-K, filed with the Securities and Exchange Commission (SEC) on April 1, 2002. As shown in the accompanying Condensed Consolidated Financial Statements, the Company continues to incur losses and negative cash flows from operations. At September 30, 2002, the Company had cash and cash equivalents of approximately $2.3 million. Management believes that its current cash and proceeds from the recent private placement of preferred stock, which closed on October 31, 2002, will allow the Company to continue its operations, fund working capital and capital expenditures through September 30, 2003. The Company s need for additional financing will depend upon numerous factors, including, but not limited to, net cash used in operating activities, including the progress and scope of ongoing research and development projects, the costs of training physicians to become proficient in the use of the Company s products and procedures, the ability to obtain additional FDA approvals, the ability to successfully defend itself in any current or future patent litigation and the ability of the Company s customers to obtain medical reimbursement from third party payors.

The Company applies the provisions of Staff Accounting Bulletin No. 101 (SAB 101) when recognizing revenue. SAB 101 states that revenue generally is realized or realizable and earned when all of the following criteria are met: a) persuasive evidence of an arrangement exists, b) delivery has occurred or the services have been rendered, c) the seller s price to the buyer is fixed or determinable, and d) collectibility is reasonably assured.

The Company recognizes revenue from the sale of products, including supplies and accessories, to end-users once shipment has occurred (as the Company s general terms are FOB shipping point). In those few cases where the terms are FOB customer s plant, revenue is not recognized until the Company receives a signed delivery and acceptance certificate, and all of the conditions of SAB 101 (items a. through d., as identified above) have been met. Revenue is recognized from the performance of services as the services are performed.

The Company recognizes revenue from the sale of products, including supplies and accessories, to distributors once shipment has occurred (as the Company s general terms are FOB shipping point), and all of the conditions of SAB 101 have been met. The Company s distributors do not have rights of return or cancellation. Revenues from distributors that do not meet all of the requirements of SAB 101 are deferred and recognized upon the sale of the product to the end-user.

Revenues from product sales to customers, which are financed by third party financing institutions, are recognized by the Company when a purchase order is received, the product has been shipped and the funding by the financing institution has been approved.

Table of Contents

Revenues for transactions that include multiple elements such as systems, training, product warranties, instruments, accessory kits and service contracts are allocated to each element based on its relative fair value (or in the absence of fair value, the residual method) and recognized when the revenue recognition criteria have been met for each element. The Company recognizes revenue for delivered elements only when the following criteria are satisfied: (1) undelivered elements are not essential to the functionality of delivered elements, (2) uncertainties regarding customer acceptance are resolved and (3) the fair value for all undelivered elements is known.

The Company defers revenue from the sale of extended warranties, product upgrades, procedure training contracts and other contractual items and recognizes them over the life of the contract or upon shipment to the customer, as applicable.

Shipments of products to be used for demonstration purposes or prototype products used in development programs are reflected as consigned inventory and are included in the property and equipment balance in the accompanying consolidated balance sheets. Revenue recognized on the rental of this equipment is recognized as development revenue over the term of the agreement.

The Company records revenue, net of commissions paid to agents, in accordance with Emerging Issues Task Force (EITF) No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent.

The Company believes that Statement of Position 97-2, Software Revenue Recognition (SOP 97-2), is not applicable to the sale of the Company s products in accordance with the guidance in paragraphs 2 and 4 of SOP 97-2. The Company considers the software that it sells incidental to its products sold. In addition, such software is not a significant focus of the Company s marketing efforts nor is the software sold separately. Also, post contract customer support is not sold by the Company in conjunction with the software. As a result, the Company does not separately account for the sale of the software.

Note 2. Net Loss Per Share

Statement of Financial Accounting Standard (SFAS) No. 128, Earnings Per Share, requires that the Company present both basic and diluted net loss per share in its financial statements. The Company s basic net loss per share is the same as its diluted net loss per share because inclusion of outstanding stock options and warrants in the calculation is antidilutive. Basic and diluted loss per share is calculated by dividing net loss available to common stockholders by the weighted average number of common shares outstanding for the period.

The net loss per share for the nine months ended September 30, 2002 has been adjusted to include the present value of the dividends paid on the shares of the Company s Series B Convertible Preferred Stock of $1,193,000 and the write off of the beneficial conversion feature of such shares of $3,785,000. The Company is required to recognize these items as a dividend in the net loss computation for loss per share (See Note 4 as all of the remaining shares of Series B Convertible Preferred Stock were converted into shares of common stock on February 13, 2002).

Table of Contents

	(Amounts in thousands, except per share amounts) (unaudited)							
	For the three months ended September 30,				For the nine months ended September 30,			
	2002		2001		2002		2001	
	Amount	Per share	Amount	Per share	Amount	Per share	Amount	Per Share
Unaudited per share data - basic and diluted:								
Net Loss and net loss per share--(Unaudited)	$(5,526)	$(0.32)	$(2,937)	$(0.28)	$(14,918)	$(0.91)	$(12,437)	$(1.22)
Fair Value of warrants issued in connection with the Series B Convertible Preferred Stock							(1,536)	$(0.15)
Cumulative dividend on the Series B Convertible Preferred Stock			(61)	(0.01)			(153)	$(0.02)
Additional shares issued due to a reset provision of the Series B Convertible Preferred Stock			(246)	(0.02)			(246)	$(0.02)
Present Value of dividend on the Series B Convertible Preferred Stock					(1,193)	(0.07)		
Beneficial Conversion feature of the Series B Convertible Preferred Stock					(3,785)	(0.23)	(1,066)	$(0.10)
Net loss available to common shareholders and net loss per share	$(5,526)	$(0.32)	$(3,244)	(0.31)	$(19,896)	$(1.21)	$(15,438)	$(1.51)

Note 3. Inventories

Inventories, which include materials, labor and overhead, are stated at the lower of cost or market. The Company uses the first-in, first-out (FIFO) method to value inventories. The components of inventories are as follows:

	(Amounts in thousands)	
	(unaudited)	
	September 30, 2002	December 31, 2001
Raw materials	$ 3,251	$3,200
Work in process	892	470
Finished goods	2,879	2,183
Total inventories	$ 7,022	$5,853

Table of Contents

Note 4. Private Placement of Common Stock and Conversion of Series B Convertible Preferred Stock

On February 13, 2002, the Company raised net proceeds of approximately $10,527,000 through the sale and issuance of shares of its common stock to certain institutional and accredited investors, including approximately $100,000 from Robert W. Duggan, the Company s Chief Executive Officer and Chairman. The proceeds from the sale of the Company s common stock were used to retire approximately $2,360,000 in debt (including the remaining principal and accrued interest of $968,000 under a promissory note payable to Mr. Duggan) and the remainder of the proceeds were used to fund working capital needs due to investments in clinical trials, research and development, sales and marketing programs and for other general operating requirements. In February 2002, the Company issued 328,689 additional shares of its common stock to certain vendors who agreed to cancel approximately $1,395,000 of accounts payable owed to these vendors as consideration for their shares.

On February 13, 2002, the holders of the Company s Series B Convertible Preferred Stock entered into agreements with the Company whereby they agreed to convert all of their remaining shares of Series B Convertible Preferred Stock into shares of common stock. The Company issued 2,196,341 shares of its common stock upon conversion of the Series B Convertible Preferred Stock. In connection with this conversion, the Company agreed to pay to the holders the present value of the future dividends payable on their shares of Series B Convertible Preferred Stock. This dividend payment was made by the issuance of 312,869 shares of the Company s common stock. The Company also agreed to reduce the exercise price of certain warrants issued to the holders of its Series B Convertible Preferred Stock from $8.12 to $5.00 per share.

Note 5. Note Payable - Accounts Receivable Financing

In January 2002, the Company entered into a secured, revolving line of credit (or factoring agreement) with a third party financing company. This line of credit provided for borrowings up to $2,000,000 based on eligible domestic trade receivables at a factoring fee of 2%, plus a financing fee of prime rate plus 3% and was secured by all the assets of the Company. The six-month term of this revolving line of credit expired in July 2002 and was not renewed. As of September 30, 2002, no amounts were outstanding under the accounts receivable financing agreement.

Note 6. Equity-based Line of Credit

On March 30, 2001, the Company entered into an Equity Line Financing Agreement with Société Générale, under which the Company was entitled to issue and sell, from time to time, shares of its common stock for cash consideration up to an aggregate of $12 million. In February 2002, the Company terminated the Equity Line Financing Agreement. In connection with this termination, the Company paid a one-time settlement fee of $135,000 to Société Générale. Prior to terminating the Equity Line Financing Agreement, the Company raised approximately $508,000 by issuing 111,615 shares of its common stock to Société Générale pursuant to the terms of the Equity Line Financing Agreement.

Note 7. Note Payable to Shareholder

During the quarter ended September 30, 2002, the Company received a bridge loan advance in the aggregate amount of $1,000,000 from Robert W. Duggan, the Company s Chairman and Chief Executive Officer. Subsequent to September 30, 2002, the Company negotiated final terms of the bridge loan with another investor and, in connection therewith, the Company issued unsecured, 180-day promissory notes for

Table of Contents

$1,000,000 to Robert W. Duggan and the other bridge lender. The notes then were converted into shares of Series C Preferred Stock issued in the Company s recent private placement, except that the conversion of Mr. Duggan s note is subject to stockholder approval. Interest accrues at 8.5% per annum on the promissory notes and is convertible into shares of the Company s Series C Convertible Preferred Stock, subject to stockholder approval at a special meeting to be held early next year (See Note 12 Subsequent Event).

Note 8. Segments of Business

The Company adopted SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. SFAS 131 establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to stockholders. SFAS 131 also establishes standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision-making group, in making decisions how to allocate resources and assess performance. The Company s chief decision-making group, as defined under SFAS 131, is the Executive Staff, which is comprised of the President, Chief Executive Officer, Chief Technology Officer, Chief Financial Officer and Chief Accounting Officer. To date, the Executive Staff has viewed the Company s operations as principally one segment (For consistent presentation certain amounts have been reclassified in prior periods in order to conform to the current year presentation): proprietary robotic and computerized surgical systems for the medical device industry. Sales by product lines within this segment are as follows:

Revenue by product line for the three months ended
(Amounts in thousands)

	Sep. 30, 2002	Jun. 30, 2002	Sep. 30, 2001
ZEUS surgical systems	$ 601	$ 983	$2,631
AESOP surgical systems	1,455	1,860	2,414
SOCRATES telementoring systems	96	408	305
HERMES (systems, development, and supplies)	1,230	685	903
Grant revenue	132	101	
Development revenue			268
Recurring revenue	1,020	1,027	637
	$4,534	$5,064	$7,158

Units sold by product line for the three months ended

	Sep. 30, 2002	Jun. 30, 2002	Sep. 30, 2001
ZEUS surgical systems	1	1	4
ZEUS surgical systems upgrades	2	3	3
AESOP surgical systems	22	26	34
SOCRATES telementoring systems	1	5	4

Export sales are made by the United States operations to the following geographic locations:

For the three months ended
(Amounts in thousands)

	Sep. 30, 2002	Jun. 30, 2002	Sep. 30, 2001
Canada	$ 571	$ 766	$
Europe and the Middle East	492	756	3,240
Asia	275	743	367
South America & Mexico	7	320	172
	$1,345	$2,585	$3,779

Table of Contents

Note 9. Concentration of Risk

For the quarter ended September 30, 2002, the Company had no single customer that accounted for more than 10% of revenue or accounts receivable. For the same period in 2001, the Company had one customer that accounted for approximately 10% of both revenue and accounts receivables. For the nine months ended September 30, 2002 and 2001, no single customer accounted for more than 10% of revenue or accounts receivable.

A sub-assembly of the robotic arms, which are a major component of the Company s AESOP and ZEUS products, is purchased from a single supplier. The Company believes that other suppliers would be available for the sub-assembly if necessary.

Note 10. Litigation

On May 10, 2000, the Company filed a lawsuit in United States District Court alleging that Intuitive Surgical s da Vinci surgical robot system infringes on its United States Patent Nos. 5,524,180, 5,878,193, 5,762,458, 6,001,108, 5,815,640, 5,907,664, 5,855,583 and 6,063,095. Subsequently, Computer Motion s complaint was amended to add allegations that Intuitive s da Vinci surgical robot infringed two additional Computer Motion patents United States Patent Nos. 6,244,809 and 6,102,850. These patents concern methods and devices for conducting various aspects of robotic surgery. Intuitive has served an Answer and Counterclaim alleging non-infringement of each patent-in-suit, patent invalidity and unenforceability. Discovery is still underway. The parties have filed cross motions for summary judgment on the issue of patent infringement relating to the 108, 664, 809, and 850 patents which have not been ruled upon by the Court at the present time. Trial is set for April 2003.

On or about December 7 and 8, 2000, the United States Patent and Trademark Office (USPTO) granted three of Intuitive s petitions for a declaration of an interference relating to the Company s 5,878,193, 5,907,664, and 5,855,583 patents. On March 30, 2002, the three judge panel of the Board of Patent Interferences issued decision orders on the parties preliminary motions. The Board granted the Company s motion on Interference No. 104,643 and issued an order for Intuitive to show cause why judgment should not be entered against Intuitive on this interference. The Board denied the Company s motion on the Interference No. 104,644 and entered judgment against the Company. The Board denied the Company s motions on the Interference No. 104,645, deferred decision on two of Intuitive s motions, and granted-in-part, denied-in-part and deferred-in-part on one of Intuitive s motions. The Board s decision on Interference No. 104,645 invalidated some of the parties claims, affirmed some of Intuitive s claims and provided for further proceedings related to two of our claims and is therefore not final. On July 25, 2002, Computer Motion filed a civil action seeking review of the two adverse decisions in the United States District Court for the District of California.

On February 21, 2001, Brookhill-Wilk filed suit against the Company alleging that its ZEUS surgical system infringed upon Brookhill-Wilk s United States Patent Nos. 5,217,003 and 5,368,015. Brookhill-Wilk s complaint sought damages, attorneys fees and increased damages alleging willful patent infringement. On March 21, 2001, the Company served its Answer and Counterclaim alleging non-infringement of each patent-in-suit, patent invalidity and unenforceability. On November 8, 2001, the United States District Court for the Southern District of New York in the co-pending Brookhill-Wilk v. Intuitive Surgical, Inc., Civil Action No. 00-CV-6599 (NRB), issued an order interpreting the claims of Brookhill-Wilk s Patent No. 5,217,003 in a way that the Company believed excluded current applications of its ZEUS surgical system. In light of this decision, on November 13, 2001, the parties to Brookhill Wilk v. Computer Motion, Inc. agreed to dismiss the case without prejudice.

Table of Contents

On March 30, 2001, Intuitive and IBM Corporation filed suit alleging that the Company s AESOP, ZEUS and HERMES products infringe United States Patent No. 6,201,984 which was issued on March 13, 2001. The complaint seeks damages, a permanent injunction, and costs and attorneys fees. Each of the asserted claims is limited to a surgical system employing voice recognition for control of a surgical instrument and literally read on Computer Motion s current AESOP product and Computer Motion s ZEUS and HERMES products to the extent they are used with AESOP. A jury trial has been held on the issues of patent invalidity due to lack of enablement and failure to disclose the best mode in addition to damages. The Company s defense of unenforceability due to prosecution laches was tried before the District Court Judge. The jury returned a verdict finding IBM s United States Patent No. 6,201,984 valid, and finding Intuitive was damaged in an amount of $4.4 million. Prior to the jury s verdict, the court ruled that the Company had not willfully infringed the patent. The court has not, at this time, given its verdict on the Company s prosecution laches defense. A verdict in the Company s favor on the prosecution laches defense could result in a finding that the patent is not enforceable and negate the damages verdict.

On September 20, 2002, a lawsuit was filed against the Company by Endoscopic Technologies, Inc., alleging breach of contract and related claims arising out of an agreement entered into between the two companies pursuant to which Endoscopic purchased equipment from the Company and was to become a distributor for the Company s products. The lawsuit, which is currently pending in the Superior Court of California for the City and County of San Francisco, was recently served on the Company and no answer has been filed. The Company contends that the action is without merit and plans to vigorously defend this action. In addition, the Company will likely be filing a cross-complaint against Endoscopic seeking payment of more than $100,000 in outstanding invoices.

Note 11. Recent Accounting Pronouncements

In August 2001, the Financial Accounting Standards Board issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, (SFAS 144). SFAS 144 supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of and the accounting and reporting provisions of APB Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, , for the disposal of a segment of a business (as previously defined in that Opinion). SFAS No. 144 also resolves significant implementation issues related to Statement 121.

The FASB recently approved two pronouncements: SFAS No 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets, which provide guidance on the accounting for business combinations to be accounted for using the purchase method. Under the new rules, goodwill will no longer be subject to amortization over its useful life. Rather, goodwill will be subject to at least an annual impairment assessment. This assessment is a fundamentally different two-step approach and is based on a comparison between a reporting unit s fair value and its carrying value. Intangible assets have newly defined criteria and will be accounted for separately from goodwill and will continue to be amortized over their useful lives.

The Company adopted these three pronouncements on January 1, 2002. The adoption of these three standards did not have any impact on its results of operations or its financial position.

Note 12. Subsequent Event

On October 31, 2002, the Company completed a private placement to issue 7,726 shares of Series C-1 Convertible Preferred Stock and 1,071 shares of Series C-2 Convertible Preferred Stock at a purchase price of $1,400 per share for an aggregate amount of $12,315,400 with certain institutional and accredited investors,

Table of Contents

including members of management. This offering will result in net cash to the Company of approximately $11,500,000. To date, the Company has received approximately $9,000,000 (including $1,000,000 of proceeds from a note payable to stockholder, see Note 7) and expects to receive $1,500,000 from one investor on or about November 15, 2002, and an additional $1,000,000 from Robert W. Duggan, (or his affiliates or designees), Chairman and Chief Executive Officer, upon the stockholder s approval of this equity offering at a special meeting to be held early next year. Concurrently with the private placement, the Company issued warrants for the purchase of up to 3,518,690 shares of the Company s common stock.

The Series C-1 Convertible Preferred Stock and the Series C-2 Convertible Preferred stock (the Preferred Stock) have identical rights, preferences and privileges except with respect to the manner in which the Company may pay accrued dividends as described below. The Preferred Stock is convertible into shares of the Company s common stock at an initial conversion price of $1.40 per share. The holders of Preferred Stock shall receive a preferred annual dividend at a rate of 12.0% per annum, decreasing to 8.0% upon stockholder approval of the transaction and increasing to 12.0% on the second anniversary of the initial issuance date. Dividends on the Series C-1 Convertible Preferred Stock may be paid by the Company, at its option, through the issuance of shares of common stock or cash, and dividends on the Series C-2 Convertible Preferred Stock may only be paid in cash. In addition, the investors were granted two series (Series C-1 and C-2 Warrants) of 5-year warrants to purchase an aggregate of approximately 3,518,690 shares of the Company s common stock. The Series C-1 Warrants to purchase 1,759,345 shares of common stock are exercisable at a price of $1.80 per share and the Series C-2 Warrants to purchase 1,759,345 shares of common stock are exercisable at a price of $2.20 per share. The Series C-1 Warrants are redeemable if the Company s common stock trades at or above $3.00 per share for ten consecutive trading days and the Series C-2 Warrants are redeemable if the Company common stock trades at or above $4.40 per share for ten consecutive trading days. The Securities and Exchange Commission (SEC) and National Association of Stock Dealers and Automated Quotation (NASDAQ) rules require shareholder approval for private financing in excess of 20% of the total shares outstanding. The Company will be seeking stockholder approval for the conversion of the Preferred Stock in an amount that exceeds 19.99% of the total outstanding common stock on the date of issuance at a special stockholders meeting to be held early next year. Please see the Company s Current Report on Form 8-K, as filed on November 4, 2002, for a description of the terms.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This report contains forward-looking statements that involve risks and uncertainties. The Company s actual results may differ materially due to factors that include, but are not limited to, the risks discussed herein under Risk Factors That May Affect Future Results as well as those discussed in the Risk Factors That May Affect Future Results section of the Company s Annual Report on Form 10-K for the year ended December 31, 2001.

OVERVIEW

Computer Motion is a high-tech medical device and training company developing surgical practices with the goal of ushering in a new era of patient and physician friendly surgery. This new era is expected to significantly reduce patient trauma, recovery time and dramatically reduce the learning curve of surgeons adapting these new, less invasive techniques. The Company s products automate operating room tasks and simplify various aspects of surgical procedures, reducing operating cost and time. Computer Motion s products, including surgeon training and education services, play a significant role in transitioning the surgical community from open procedures to less invasive procedures increasingly demanded by patients. As the leader in computer-enhanced surgical systems for minimally invasive procedures, Computer Motion holds 27

Table of Contents

patents, with over 50 additional patents pending. Computer Motion s products have been successfully used across a broad range of surgical disciplines including cardiac, urology, pediatrics, bariatrics and general surgery.

The Company develops and markets robotic and computerized surgical systems that are upgradeable and based on an open system platform, which allows for networking of the entire operating room. These systems enhance a surgeon s performance and centralize and simplify a surgeon s control of the operating room. Computer Motion s products provide surgeons with the natural functionality necessary to perform complex, minimally invasive surgery (MIS) procedures, as well as enable surgeons to control critical devices in the operating room through simple verbal commands. The Company believes its products will broaden the scope and increase the effectiveness of MIS, improve patient outcomes, and create a safer, more efficient and cost-effective operating room.

Computer Motion s suite of products includes the **ZEUS® Surgical System, AESOP® Robotic Endoscope Positioner, HERMES® Control Center** and **SOCRATES Telecollaboration System,** all of which are FDA cleared for various indications. In addition, the Company s products have been approved for Class III (General Surgery) and Class IV (Cardiac) licenses in Canada, and have received the CE mark for sale in Europe.

The ZEUS Surgical System is designed to fundamentally improve a surgeon s ability to perform complex MIS procedures. The Company expects to enable new MIS procedures involving a range of surgical disciplines, including fully endoscopic coronary artery bypass grafts or E-CABG grafts on a beating heart. ZEUS augments surgeon performance by providing 3-D visualization of the operating area, filtering out hand tremor and scaling human motion. A recent addition to ZEUS is the new MicroWrist surgeon interface, which has a natural feel similar to an open procedure to improve dexterity and reduce the learning curve in using the system.

ZEUS system s three compact, portable arms hold and position reusable microsurgical instruments and an endoscope. Each arm is individually mounted on the operating room table using the standard table rails. Because the arms are attached to the table, the table can be adjusted during a surgical procedure without removing the instruments. The surgeon sits near the operating room table at an open, comfortable and portable console. The open design of the console provides the surgeon with an unobstructed view of the patient and allows clear communication with the operating room staff. At the console, the surgeon controls the instrument handles and views the operative site on a video monitor. ZEUS senses the surgeon s hand movements through the new MicroWrist surgeon interface. It then scales the surgeon s hand movements into precise, tremor-free micro movements at the operative site.

ZEUS is FDA cleared for sale in general laparoscopic surgery. This clearance allows clinical use of the ZEUS system for a broad set of general surgery applications such as laparoscopic cholecystectomy and laparoscopic nissen fundoplication. The Company is also seeking additional FDA clearances for thoracic surgery, laparoscopic radical prostatectomy and cardiac procedures, with clinical trials ongoing.

AESOP, the first of Computer Motion s revolutionary line of robotic surgical devices, enables endoscopic visualization with stability and clarity. It was FDA cleared in 1993. AESOP is an integral part of the ZEUS system. AESOP is a voice-controlled robotic arm (one of the three arms in ZEUS) that positions and holds an endoscope with steadiness and precision during MIS procedures. It mimics the human arm in form, function and expanded range of motion. AESOP s voice-activation system, created specifically for the operating room, recognizes only the surgeon s authorized commands. Powered by the HERMES Control Center, AESOP can also be networked with a wide variety of other voice-controlled surgical and operating room devices. The Company believes that AESOP is the world s first FDA-cleared robot and first voice controlled interface for a surgical device. The Company has sold over 700 AESOP units worldwide, which the Company believes have been used to perform over 175,000 procedures.

Table of Contents

The **HERMES Control Center** is designed to integrate all the devices in the operating room and provide the surgeon and the operating room staff with a consistent and unified interface to control all devices. The primary input for the surgeon using the Hermes Control Center is through the use of simple speech commands. The HERMES system was designed as an open architecture platform simplifying the process for medical device manufacturers to create HERMES-ready devices. The HERMES Control Center is a platform to provide surgeons and operating room staff with quicker access to information and increased control over their environment. Today s offices include computers that are networked to printers, fax machines, modems, scanners and other enabling tools. Similarly, HERMES allows the operating room to be networked with OR-specific equipment, such as tables, lights, cameras and surgical equipment. These HERMES-Ready devices can be controlled by surgeon voice commands or by way of a hand-held touch-screen pendant.

The 27 FDA-cleared devices controlled by the HERMES system include endoscopic cameras, overhead cameras, light sources, insufflators, arthroscopic shavers, fluid pumps, VCRs, printers, video frame grabbers, digital image capture devices, OR lights, surgical tables, electrosurgical units, telephones and the Company s port expander, and the AESOP and ZEUS systems. The HERMES compatible, or HERMES -Ready interfaces for these devices were created in collaboration with various HERMES alliance partners, including Stryker Endoscopy, Berchtold, Steris, Valley Lab (TYCO), and Smith & Nephew Endoscopy.

SOCRATES links surgeons in the operating room with colleagues anywhere in the world. It is the first and only device in a newly created FDA category of Robotic Telemedicine Devices. It promotes peer-to-peer and mentor-trainee collaboration and makes it possible for specially trained surgeons to become interactively telepresent wherever and whenever needed. SOCRATES creates surgical telepresence through the remote surgeon s graphical annotation of the operating field and shared control of the endoscope, as well as through two-way video and audio communication. The Company believes that by facilitating truly interactive dialogue between geographically separated colleagues, SOCRATES provides the foundation for a new era of surgical teamwork and training.

RESULTS OF OPERATIONS

The Company has sustained significant losses since inception and, as of September 30, 2002, has an accumulated deficit of $104,491,000. The Company expects to incur additional losses as it continues to fund research and development efforts, clinical trials, and seeks to expand its manufacturing capacity and sales force. As a result, the Company will need to generate significant revenues in order to achieve and maintain profitability. The Company is not certain that it will ever achieve significant commercial revenues, particularly from sales of its ZEUS product line, which is still under development and awaiting additional FDA clearances for certain applications and procedures, or that the Company will ever become profitable. It is possible that the Company may encounter substantial delays or incur unexpected expenses related to, among other things, additional clinical trials, market introduction and acceptance of the ZEUS platform or any future products and litigation required to protect its intellectual property portfolio. If the time required to generate significant revenues and achieve profitability is longer than anticipated, the Company may not be able to continue its operations.

The Company is penetrating only a small fraction of the total potential market for its products. Although many medical conditions that are treatable using the Company s products are also treatable using pharmaceuticals and other medical devices, the Company does not believe that it encounters direct competition for its AESOP, HERMES or SOCRATES products. The Company believes that it has only one direct competitor for its ZEUS product. Its AESOP, HERMES, SOCRATES and ZEUS products are comprised of relatively new technologies, and the current customer profiles are made up of healthcare organizations that share the Company s pioneering vision for these new technologies. Thus, the Company does not believe that there is any statistical significance to its quarterly increase or decrease variations in business levels. However,

Table of Contents

the Company believes that its products acceptance and adoption will be positively influenced by the recent FDA clearance for sale in general laparoscopic surgery for the Company s ZEUS product. The challenges the Company faces in its attempt to increase market share today include market acceptance, regulatory clearance, surgical procedure adoption (such as Endoscopic Atraumatic Coronary Artery Bypass or Endo-ACAB surgery) and adoption of robotic technologies In addition, the Company believes that the sales cycle for capital medical equipment is approximately three to six months, especially for innovative technologies like the Company s AESOP, HERMES, SOCRATES and ZEUS products. Thus, sales in the first quarter originate in the fourth quarter of the prior year. The Company also believes that prospecting for new sales tends to fall off in the fourth quarter since its sales focus is on closing sales for the current calendar year and because there are fewer working days available due to the holiday season.

With the above understanding, the analysis of the Company s quarterly revenue changes is as follows:

Three months ended September 30, 2002 compared to the three months ended September 30, 2001.

Revenue. Revenue decreased $2,624,000, or 37%, to $4,534,000 for the quarter ended September 30, 2002 from $7,158,000 for the quarter ended September 30, 2001. ZEUS revenue of $601,000 for the quarter decreased $2,030,000 over last year s second quarter of $2,631,000 due to a decrease in the number of units shipped which we believe was, in part, due to the delay in the Company s receipt of FDA approval. AESOP revenue of $1,455,000 for the quarter decreased $959,000 over last year s second quarter of $2,414,000 due to fewer systems being shipped. HERMES revenue of $1,230,000 for the quarter increased $327,000 over last year s second quarter of $903,000 due to an increase in the number of units shipped as well as an increase in supplies and accessories sales. SOCRATES revenue of $96,000 for the quarter decreased $209,000 over last year s second quarter of $305,000 due to fewer units being shipped. Grant revenue of $132,000 for the quarter ended September 30, 2002 resulted from a 3-year NIST grant the Company received in the fourth quarter of 2001. Development revenue of $268,0